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Net Benefits of a Jordan-US Double Tax Agreement

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Net Benefits of a Jordan-United States Double Tax Agreement

Final Report

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Abstract

This report assesses the net benefits to Jordan of negotiating a double tax agreement (DTA) with the United States. The main message of this report is that DTAs are not 'quick wins', either in terms of increasing Jordan's income tax revenue, increasing foreign direct investment into Jordan, or improving Jordan's income tax policy. This is true even if the potential treaty country is one of Jordan's major trade and investment partners, such as the United States. In fact, this report recommends that Jordan suspend its double tax treaty negotiating program while it commences a comprehensive review of its income tax system and its double tax treaty program.

Abbreviations and Acronyms

DTA	Double Taxation Agreement
EFTA	European Free Trade Agreement
EOI	Exchange of information
FDI	Foreign direct investment
GDP	Gross domestic product
GST	General sales tax
IMF	International Monetary Fund
IRC	Internal Revenue Code
ITL	Income Tax Law
JD	Jordanian dinar
LOB	Limitation of benefit
MNE	Multinational enterprise
OECD	Organisation for Economic Cooperation and Development
UN	United Nations

A Caveat and Acknowledgements

This consultancy made a major effort to be accurate in its statement of Jordanian income tax law and practice, at a high cost in terms of research time. Ironically, Jordan's Income Tax Law may be relatively brief compared to income tax legislation in most countries but it is a very expensive process gathering a comprehensive and up-to-date set of Jordanian income tax law, regulations, instructions, double tax treaties, and formal decisions made under income tax law by the Council of Ministers, the Minister of Finance, the Director General of the Income Tax Department, and departmental officials.

At present, even businesspeople and tax advisers in Amman complain about the difficulty of getting prompt access to the Jordanian income tax law. The release to a member of the public of a new Jordanian double tax agreement (DTA) that had entered into force, we were told, had required the approval of the Director General of the Income Tax Department.

The websites of the Income Tax Department and the Jordanian Embassy in Washington, DC, for example, do not have up-to-date versions of Jordan's Income Tax Law. The Income Tax Department website does not contain any of Jordan's DTAs. One of the most comprehensive DTA databases in the world, which is used by many international tax practitioners around the world, is out-of-date in respect to Jordan. The Tax Treaties Database run by the International Bureau of Fiscal Documentation in Amsterdam, the Netherlands, records that Jordan currently has 11 DTAs in force (in fact, Jordan has 17). It publishes the text of 10 of those 17 DTAs only. Finally, to obtain the non-English DTA texts of another four of Jordan's DTAs (those in Arabic and Polish), it is necessary to contact the organization and pay 50 Euro for a copy of each Arabic or Polish DTA text.

In section 8.3, this report makes recommendations about the need to improve the availability, promptness and reliability of Jordan's income tax law, understood in the broadest sense, to include Jordan's Income Tax Law, regulations, instructions, double tax treaties, and formal decisions made under income tax law by the Council of Ministers, the Minister of Finance, the Director General of the Income Tax Department and departmental officials.

Having said that, this consultancy would like to acknowledge the generous support that it received from both the public and private sector in Jordan. Jordan's Income Tax Department kindly prepared an English version of the Income Tax Law, provided copies of some Jordan's double tax treaties unavailable from public sources and prepared a list of Jordan's double tax treaties and current treaty negotiations. Tax advisers and businesses in Jordan also gave generous support, including checking our statement of Jordan's current law.

Despite all that effort and all that assistance, this report may still have some (hopefully small) errors. As the report was being completed and our statement of Jordan's current law was being checked with a Jordanian tax adviser for a final time, errors in that English version of the Jordanian Income Tax Law were still being discovered. This report draws on a long-term research project that the author is undertaking on international tax and double tax treaty policy options for small, open economies. Part of this research has been funded by the Faculty of Commerce and Administration at the Victoria University of Wellington, New Zealand.

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Executive Summary

Overview

> *One of the central challenges facing low income and developing countries is to mobilize sufficient tax revenue to sustainably finance, when combined with whatever aid is available, the expenditures needed for growth and poverty relief—and to do so in a way that does not itself undercut those objectives by unduly worsening preexisting distortions or inequities. … [T]en years is a relatively short period in the life of a tax system—indeed that may be one of the central lessons to be drawn from the analysis in the paper …*[1]
>
> *Two IMF economists reflecting on tax policy lessons from the 1990s.*

> *Among these "quick win" decisions advocated for in this report are the following:*
>
> *Concluding negotiations and work related to entering into a double taxation agreement with the United States, the European Union, and European Free Trade Agreement (EFTA) states.*[2]

Jordan has been opening its economy to international capital to achieve higher growth and a better standard of living for all Jordanians. It particularly seeks foreign direct investment that will provide more competition and innovation, as well as the transfer of technology and ideas to Jordan. At the same time, Jordan needs revenue and a credible fiscal plan to reduce its high debt burden and its dependence on external grants. **For a small open economy that is both heavily reliant on foreign investment and that needs to raise more income tax revenue, the risks from poor policy design and administration of Jordan's income tax system are great**:

- foreign investment, with skills and technology it brings, may be discouraged;
- the domestic cost of capital for firms in Jordan may be increased;
- foreign and domestic investment may make an inefficient use of Jordan's resources;
- income tax revenue may be transferred to another country for no increased investment in Jordan;
- income tax revenue may fall as a result of increased avoidance and evasion;
- Jordan may become an unattractive place from which to do business in the region; and,
- Jordanians may increasingly question the fairness of their tax system.

Since 1984, Jordan has been using two tax instruments to attract foreign investment: tax holidays and double tax treaties. A recent AMIR Program report recommended that Jordan should stop granting income tax exemptions and reductions to new investment projects. Instead, it proposed import duty exemption for all fixed capital assets used in business, a 20 percent investment allowance for capital invested in machinery and

[1] Keen, Michael and Alejandro Simone, *Tax Policy in Developing Countries: Some Lessons from the 1990s, and Some Challenges Ahead*, manuscript, p 2. To appear in Sanjeev Gupta, Ben Clements, and Gabriela Inchauste (eds): Helping Countries Develop: The Role of the Fiscal Policy..

[2] *The 2002 Investor Roadmap of Jordan*, manuscript, p 214. See also pp 14, 21, 162 & 169.

equipment for business use and a capital expensing election for small and medium entrepreneurs. The report emphasised the need to reformulate Jordan's investment incentives program as part of the comprehensive tax reform programme envisaged in *Jordan Vision 2020*.

Under the current income tax system with every DTA that Jordan negotiates:

- **Jordan gives away income tax revenue.** Jordan largely taxes only income earned in Jordan and all of Jordan's DTAs reduce its right to tax that income. There is no offset for Jordan, as there is for countries that tax their residents on their foreign income, like the United States. Each of Jordan's DTAs gives Jordan greater taxing rights in relation to the foreign income of its residents. Jordan largely chooses not to exercise those rights in its domestic tax law.

- **Jordan accepts responsibility to help one more country administer its tax system and gets little or no help in return**, as Jordan's income tax is largely territorial and Jordan does not need other countries' help to enforce taxation of economic activity that occurs in Jordan.

- **Jordan does not immediately open the gates for foreign investment from that country**, as Jordan itself has found in the last 20 years. Recent economic research in the United States suggests other countries may share this experience. Using both United States and Organization for Economic Cooperation and Development (OECD) foreign direct investment (FDI) investment data, empirical research suggests that negotiating new DTAs is not very likely to increase FDI between the DTA partners and may actually decrease it for a period.

- **Jordan is likely to make the task of reforming its international income tax rules more difficult**, as DTAs are not based on good tax policy principles, and the slightly different concessions made to achieve agreement in each DTA may make some reform options more difficult.

Recommendations

This report recommends that Jordan suspend its double tax treaty negotiating program while it commences a comprehensive review of its income tax system and its double tax treaty program.

A number of specific reforms of current income tax policy and double tax agreement policy are recommended in this report – see Section 9.

Even in the specific context of assessing the net benefits of Jordan negotiating a double tax treaty with the United States, investors and their advisers insisted that most of their cross-border tax issues related to Jordan's own tax law and administration. As this is likely to be true of Jordan's investment relationships with other countries, the **immediate priority is to review and change Jordan's own tax law and administration** rather than attempt to resolve these Jordanian issues through bilateral negotiations with other countries.

A specific additional cost in relation to negotiating a DTA with the United States may arise for Jordan as Jordan will need to consider whether it is prepared to modify its banking confidentiality policy, at least in respect of 'tax fraud', as Switzerland and Luxembourg have been prepared to in order to have a DTA with the United States, and what the cost of that would be in terms of its objective of projecting Amman as an important financial center in the region.

Reviewing and implementing change in a tax system is a large and on-going task. Well may two International Monetary Fund (IMF) economists conclude from developing country experience of tax reform in the 1990s that "ten years is a relatively short period in the life of a tax system." The implication is not that Jordan can afford to wait, especially since the Jordanian central government fiscal outturn registered a large surplus in the first quarter of 2004. The implication is that Jordan should proceed immediately and start what will be a long and difficult process.

The reduction of Jordan's company and individual income tax rates was the easy part of reform. Broadening Jordan's income tax base and deciding how to tax cross-border income will be far more difficult exercises. The erosion of corporate tax revenues in developing countries generally, seemingly as a result of increased international tax competition, is one of the main developments of the 1990s that senior IMF staff identify in recent research.

Yet, if Jordan does not get its income tax reforms right, it will greatly reduce the benefits that will flow from opening its economy to international capital flows in the first place. Jordan's income tax rules are a key policy lever to ensure both foreign and Jordanian private investors face trade-offs that echo the relative costs and benefits from Jordan's national perspective.

Once Jordan determines and implements its medium-term income tax strategy, double tax treaty policy that works with Jordan's income tax law and administration to advance Jordan's economic objectives can be developed. Income tax law and double tax treaties can then complement each other in working for the same broad objective of raising the required amount of income tax revenue for Jordan at the least net economic, compliance and administrative cost and in a fair manner.

Jordan's income tax policy, law and administration will play a major role in determining what benefits flow to Jordan from opening its economy. Good tax policy, law and administration can help Jordan lift the standard of living for all Jordanians. **The time to start a comprehensive review of Jordan's income tax system is now.**

1. Introduction

This introduction first summarizes the mandate of the consultancy and how it has been interpreted in light of our consultations. Secondly, it briefly introduces some of the basic concepts of international income tax law and double tax treaties. Thirdly, it describes how the report is laid out.

This short-term consultancy was asked first to review current Jordanian international income tax law, including its existing double tax agreement (DTA) network, in preparation for a report that largely assessed the net economic benefits of Jordan negotiating a double tax agreement with one of its major economic partners, the United States. Finally, the consultancy was asked briefly to suggest an appropriate international tax regime for Jordan and to recommend future tax policy work (see section III C of the Scope of Work set out in Appendix 1 to this report). The mandate of this consultancy did not extend to considering the non-economic benefits for Jordan negotiating such an agreement with the United States.

Early in our consultations with tax officials, tax advisers and investors, it became apparent that there were major problems with Jordan's current international income tax policy, law and administration, as well as Jordan's approach to double tax treaty negotiation. Further, each DTA that Jordan was negotiating was working against Jordan's income tax revenue and policy goals, with little immediate upside in terms of attracting foreign direct investment. Accordingly, this report places greater weight on these broad issues and the urgent need for a review of Jordan's income tax system.

The second function of this section is to introduce the basic concepts of international income tax law and double tax treaties. In order to tax income, there needs to be a person who is liable to pay tax, a tax event and jurisdiction to tax. The two main concepts of jurisdiction that connect a person or a tax event to a country are 'residence' and 'source'. 'Residence' refers to the connection between a person and a country. 'Source' refers to the connection between a tax event and a country (domestic income is that income sourced in a country and foreign income is that income sourced outside a country).

A country can take one of two basic approaches to taxing cross-border income. It can choose to:

- Tax only that income that has a connection with the country - the connecting factor is that the income arises in a particular country. This more limited jurisdiction to tax is sometimes described as the territorial system of taxation or the source principle. This is Jordan's basic approach, with one exception in Article 3 (B) of the Income Tax Law (ITL); or,

- Tax all of the foreign or domestic income that has a connection with a person because they reside in a country or are a citizen of the country, as well as the income that has a connection with the country. This more expansive jurisdiction to tax is sometimes described as the worldwide system of taxation or the residence principle. This is the US basic approach.

As each country is free to decide its own basic approach to income tax and many countries have decided to tax income on a worldwide basis, there are often conflicts

between the income tax rules of various countries. The conflict between the source rules of one country and the residence of rules of another are the most common form of conflict. But even if every country in the world adopted a territorial system of taxation, there still could be conflicts between national income tax rules with two or more countries claiming that a particular category of income had its source in their territory.

Where a resident of a country earns income from a source in another country, a worldwide taxing country will tax the income on a residence basis and the territorial taxing country will tax the same income on a source basis. A consensus between countries, now represented in the domestic law of most countries, generally gives the first right of tax to the source country, leaving the residence country, which has the second right of tax, to either exempt that income from tax in the hands of its residents or to give their resident a credit for the foreign tax paid.

It is important to emphasize the point that most countries provide relief from double taxation in their own domestic laws, irrespective of whether there is a double tax treaty or not. One of the primary roles of a DTA, therefore, is not so much to give relief from double taxation as to divide up the income tax revenue on cross-border income between the two countries. In other words, DTAs are important government revenue documents.

A double tax treaty applies to the income levied on 'residents' (and 'citizens', in the case of the United States) of either of the two countries that are parties to the treaty. DTAs may give the source or residence country the sole right to tax income or they may require the two to share the right to tax income. Where the two parties to the treaty are required to share taxing rights in relation to income, double tax treaties generally limit the amount of tax that source countries may impose when they are taking their first 'bite' of tax so that the residence country has room to take a second 'bite' of tax without the total amount of taxes becoming prohibitively high.

Double tax treaties attempt to divide revenue on cross-border income between net capital importing and exporting countries by dividing income into two artificial classes: 'active' income, where the investor is actively involved in earning the income and 'passive' income where they are not. DTAs generally allow source countries larger taxing rights with respect to active income, like business or employment income. DTAs generally allow source countries smaller taxing rights with respect to passive income, for example by allowing the source country to levy low rates of gross withholding taxes at different rates: 15 percent on dividends, 10 percent on interest and 0 percent on royalties, for example. These artificial distinctions between different classes of income and the different rates of tax charged on those classes of income are two of the basic design flaws in DTAs. They enable some investors, like multinational enterprise (MNE) company groups, who can control the classification of income into tax-favored categories, to manipulate where, and sometimes whether, they pay tax on their income.

DTAs also provide governments that have worldwide income tax systems with a very important means of enforcing their income tax on foreign source income of their residents. As a consequence, the administrative arrangements for resolving disputes and exchanging taxpayer information are critical parts of DTAs for countries, like the United States, who tax their residents and citizens on their worldwide income.

Section 2 of this report describes Jordan's economic objectives that are relevant for double tax treaty making – Jordan's investment, revenue, income tax and banking objectives. Section 3 outlines and discusses the most important elements of current US double tax treaty policy to take into account in assessing whether a DTA with the United States would provide net benefits to Jordan. Section 4 identifies current income tax issues in the Jordanian and US income tax systems for investment between Jordan and the United States. The various ways in which these issues for investment between Jordan and the United States can be resolved are considered in section 5. Section 6 explains how DTAs can harm Jordan's economic objectives. Section 7 briefly illustrates how to think about an appropriate combination of taxes on the cross-border business income of residents and non-residents for a small open economy, like Jordan, which both imports and exports capital. Section 8 sketches future work for Jordan in this area. The report ends with recommendations in Section 9.

2. Jordan's Investment, Revenue, Income Tax and Banking Policy Objectives

2.1 Introduction

In order to assess the net economic benefits to Jordan of negotiating a double tax agreement with United States, it is first necessary to understand Jordan's broad economic policy objectives that relate to double tax treaty making. Both economic benefits and costs need to be assessed in terms of the extent to which a Jordan-US DTA would advance or hinder these Jordanian economic policy objectives.

Jordan's four economic policy objectives that are relevant to the double tax treaty mandate of this consultancy are:

(1) double Jordan's gross domestic product (GDP) per capita in real terms by 2020 primarily by attracting significantly more foreign direct investment;[3]

(2) collect more revenue from income tax;[4]

(3) improve income tax policy formulation and administration and to enhance income tax compliance;[5] and,

(4) project Amman as a key regional financial center.[6]

The Jordanian Government uses a number of instruments to implement these four economic policy objectives, some of which are identified below. To attract more foreign direct investment, Jordan has, from 1984 onwards, been providing extensive tax incentives and negotiating a relatively high number of double tax treaties.[7] To collect more income tax revenue, Jordan has been making changes to its income tax law and administration, including negotiating double tax treaties. To project Amman's position as an important banking centre in the region, Jordan has been strengthening banking supervision[8] and banking secrecy in its banking and income tax law, making sure that its double tax treaties do not undermine that policy.

Section two briefly describes Jordan's investment, revenue, income tax and banking objectives. It also analyses the connections between each of these objectives and the double tax treaty instrument. Double tax treaties are merely one means of achieving these objectives. Like any other instrument (domestic law or administrative practice, for

[3] *Jordan Vision 2020*, p. 7.
[4] *Memorandum of Economic and Financial Policies, 2002-04*, paragraphs 21-2, p 9. Dr Michael Marto, Minister of Finance, and Dr Umayya Toukan, Governor, Central Bank of Jordan, sent this memorandum on 18 June 2002 to the Managing Director of the International Monetary Fund (IMF). The memorandum described the policies that the Government of Jordan intended to implement in the 2 years from 2002-2004..
[5] Ibid, paragraph 22, p. 9. The references to tax administration, compliance and the policy formulation in this memorandum refer to taxes generally, including the income tax.
[6] *Jordan Vision 2020*, p. 32.
[7] The Free Zones Corporation Law No 32 1984 first provided tax incentives for capital investment in Jordan. The three oldest of Jordan's double tax treaties all entered into force in 1984 (France, Romania, and Tunisia).
[8] See note 2, *Memorandum of Economic and Financial Policies, 2002-04*, paragraph 17, p. 7.

instance), they have particular features that need to be carefully assessed. Finally, section two sums up the current Jordanian approach to double tax treaty negotiation and administration.

2.2 Jordan's Investment Objectives

The Jordan Vision 2020 report, endorsed by His Majesty King Abdullah II and the Jordanian Government, argues that Jordan's goal should be to 'double Jordan's per capita GDP in real terms over the next 20 years, increasing it from the current level of approximately 1,100 dinars to 2,200 dinars by the year 2020.[9]

> *Reaching thea target per capita GDP level by 2020 will require an extraordinary level of investment. Indeed, Jordan Vision 2020 estimates that 47 billion Jordanian dinars (JD) in new domestic and foreign investments will be needed, representing an average of 2.25 billion JD annually for the next 21 years. Investments of this magnitude would create hundreds of thousands of new jobs.*[10]

This blueprint document also argues that foreign direct investment will need to be the prime driving force for this growth and that Jordan needs to become much more successful in attracting foreign investment. Doubling per capita GDP can only be accomplished by attracting significant levels of foreign investment. Such investment brings capital, managerial know-how, skills development, technology transfers, and vital access to markets. Supported by innovative backward linkage programs, it also leads to increased domestic investment.[11]

This quotation argues that there is a particular relationship between two sources of investment in Jordan: foreign investment and domestic investment. It briefly identifies four reasons why it considers that Jordan should first target foreign direct investment and that domestic investment is likely to follow.

We have two preliminary comments to make on these statements of investment objective. First, there are three different types of investment that policymakers in an open economy without foreign exchange controls, like Jordan's, need to think about in devising policy, not just two. Jordanians can choose to invest offshore (exported capital) as well as onshore (domestic capital). Thirdly, foreign residents can choose to invest in Jordan (imported capital). The incentives that are created for these three different types of capital by Jordanian policy, including tax policy, can have a marked impact on Jordan's economic performance.

Secondly, in section 7 we show how Jordan's present international tax rules and, indeed, some of the suggested income tax reforms, will discourage domestic investment following foreign direct investment, unless changes are also made to Jordan's international tax rules.

Since 1984, Jordan has attempted to use tax incentives to attract foreign investment. The current Jordanian tax incentive program has been fully described and evaluated in the recent report entitled *Reformulating The Tax Incentive Program in Jordan: Analysis and*

[9] *Jordan Vision 2020*, p. 4.
[10] Ibid., p.19.
[11] Ibid., p. 4, 7.

Recommendations. The executive summary from this report is reproduced in Annex 5. That tax incentive program report concludes that the current investment incentive program is complicated, inefficient, and ineffective. It also asserts that the long history of investment incentives in Jordan has not proved to be significant in attracting capital investment in directions favored by the government but has simply eroded the base for tax revenue.

In other words, it is not a question of a trade-off between two government economic objectives producing a slightly inferior result. The report argues that the current tax incentive program is not meeting either the Jordanian government's investment or tax revenue objectives. It is not surprising, then, that the report recommends reformulating the program.

If the Jordanian government adopts the tax incentive report's recommendations, it will have implications for the timing of the comprehensive tax review as well as any intervening tax reviews, such as this one (see section 7). If Jordan stops granting income tax exemptions and reductions to new investment projects, provides a 20 percent investment allowance of the capital invested in machinery and equipment of business use and provides an annual expense election for small and medium entrepreneurs, increasing numbers of new foreign investors, who would then be making taxable income according to Jordanian ITL, would become Jordanian taxpayers.

The tax incentive implementation period, during which tax incentives already granted would be "grandfathered" to fulfill past commitments, would provide a window for reform during which relatively few foreign investors would be taxed by the current inadequate tax law and administrative practices. A comprehensive tax review is a complex task that requires time and a wide range of economic, legal, accounting, and political skills. The time to start the review is now.

2.3 Jordan's Income Revenue Objectives

The Government of Jordan's income revenue objectives for 2002-2004 were set out in a memorandum to the IMF:

> *Maintaining the buoyancy of budgetary revenues in the face of continued trade reform will require increased reliance on the GST and direct taxes. … As regards the income tax, the current revenue to GDP ratio at 3 percent of GDP is relatively low mainly because of widespread exemptions, and we will seek to raise this ratio through broadening the tax base. We also intend to unify over time the corporate and the maximum personal income tax rates and a revenue neutral manner. In order to safeguard budgetary revenues, any further rationalization of taxes or tax rates would only be considered in a manner to augment or at least protect tax revenues.*[12]

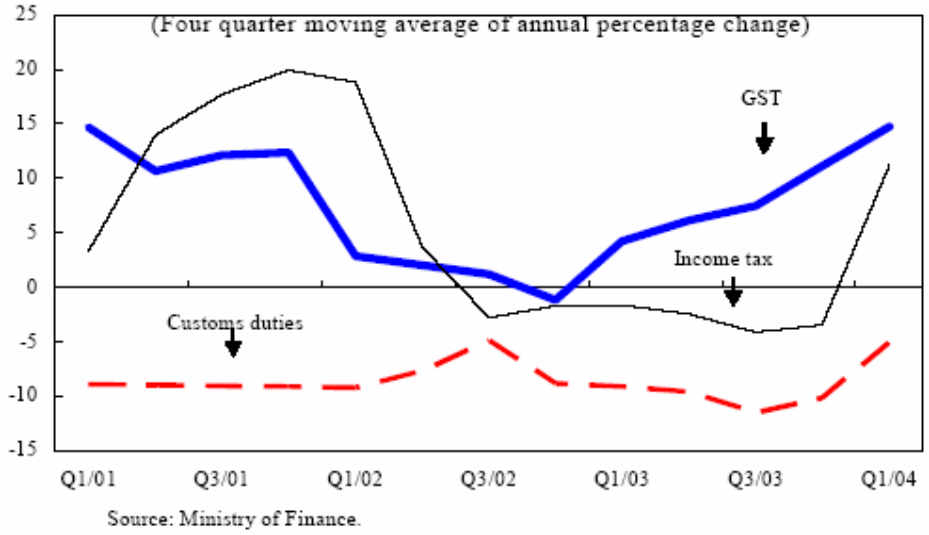
Jordan's strong fiscal performance in the first quarter of 2004 is a very good start to the year. Of particular relevance to this report are the increases in the general sales tax (GST) and income tax collections (see Figure 5 below).

[12] See note 2, *Memorandum of Economic and Financial Policies, 2002-04*, paragraph 21, p. 9.

The IMF staff report noted that:

> *Additional grants secured from neighboring countries (1.6 percent of GDP) and somewhat higher tax revenue (0.3 percent of GDP) will offset the loss of the oil surplus and increase in petroleum subsidies (1.9 percent of GDP)…Income tax receipts were also high as a result of strong corporate earnings in 2003 and better tax compliance brought about by the unification of Sales Tax and Income Tax Departments.*[13]

Figure 5. Jordan: GST, Income Tax, and Customs Duties



Source: Ministry of Finance.

That same IMF staff report, however, points out the continuing significant challenges that Jordan faces in the medium term:

> *…in the form of a high debt burden, dependence on external grants, and vulnerability through higher oil prices. Sustaining fiscal consolidation would require the elimination of the remaining subsidies on petroleum products, undertaking a comprehensive reform of the fifth direct tax system, and expenditure rationalization in line with the medium-term fiscal framework.*

If Jordan seeks most of its huge investment requirement offshore, as *Jordan Vision 2020* suggests, it will have to remain competitive with other similar foreign investment destinations in the region, including Egypt, Israel, Tunisia, and the United Arab Emirates, in terms of comparative marginal effective tax rate analysis (see Section III and IV of the AMIR report *Reformulating the Tax Incentive Program In Jordan*). If Jordan accepts the recommendations in that report and stops granting income tax exemptions and reductions to new foreign investors, it will only be able to tax this imported capital relatively lightly.

[13] International Monetary Fund, *Jordan: Third Review Under the Stand-By Arrangement; and Press Release on the Executive Board Discussion*, September 2004, IMF Country Report No. 04/287 at p 8, available at <http://www.imf.org/external/pubs/ft/scr/2004/cr04287.pdf>.

In other words, **to increase the current income revenue to GDP ratio beyond three percent of GDP is most likely to require higher income taxes on domestic capital (Jordanians investing in Jordan) and exported capital (Jordanians investing offshore) or on Jordanian labor income** (see section 7, which briefly illustrates how to think about an appropriate combination of taxes on the cross-border business income of residents and non-residents for a small open economy, like Jordan, which both imports and exports capital).

2.4 Jordan's Income Tax Policy Objectives

The call for a comprehensive review of Jordan's tax policy, law and administration has been a theme of many reports on Jordan's economy.

> *Jordan Vision 2020 contains a major section that is critical of current tax law and practice and argues for comprehensive tax reform of Jordanian policymaking, tax law and tax administration. It argues that, "[e]fficiency, fairness, transparency, and evenhanded application should be hallmarks of Jordan's tax system.*[14]

The 2002 Investor Roadmap of Jordan was also highly critical of Jordan's income tax law and administration (see the extracts in Annex 4). It suggested the initiation of a study that would examine current tax policy, tax administration, tax enforcement, and the revenue effects of changes to the tax system. In all likelihood, changes to the tax regime would yield a higher level of revenue to the treasury and remove unnecessary stress on both the public sector and the private sector. This would be an essential first step, and, in addition to a review of the system by consultants who are knowledgeable in all of these fields of taxation, the essential outcome of such a study would be very well-developed Terms of Reference for a multi-year tax reform program that would involve a new tax law, and a total restructuring of the Tax Department.[15]

Should the recent revenue buoyancy not continue in 2005, significant fiscal efforts will be needed. A recent IMF staff report recommends:

> *Reforming the **income tax** should be a key priority. The current income tax system remains overly complex, inequitable, and inefficient. As a result, Jordan's income tax performance lags significantly behind other countries in the region. The priorities for reforms in this area include: broadening the tax base by eliminating the numerous exemptions, especially on rental income and export profits; replacing the current system of deductions with a simple system of tax credits; having provisions for accelerated depreciation instead of the present system of partial tax holidays; subjecting capital gains received on all assets by all taxpayers to a similar tax; and reducing the number of tax rates to reduce the complexities of the current rate structure.*[16]

Applying the tax criteria of efficiency, fairness and transparency to the taxation of cross-border income earned on imported and exported capital is a complex exercise. Ideally, the Jordanian income tax system should not make investment overseas by Jordanian residents more or less appealing than domestic investment. Such a system is difficult to design, given that domestic rules must interact with the rules in more than 190 countries. Such a

[14] *Jordan Vision 2020*, p. 31.
[15] *The 2002 Investor Roadmap of Jordan*, p. 14.
[16] IMF, *Jordan: Selected Issues and Statistical Appendix, IMF Country Report 04/121*, May 2004, p, 95.

system is often difficult to administer, given that the capital and income are located offshore. That is a major reason why countries that tax their residents on their worldwide income negotiate double tax and tax information exchange agreements. They seek assistance from other countries in enforcing their worldwide income tax rules.

2.5 Jordan's Banking Policy Objectives

Jordan Vision 2020 argued that although Jordan's financial sector was relatively well developed for the size of its economy, Jordan's financial markets needed broadening and deepening to promote more private sector investment and to project Amman as an important financial center in the region. The report made ten recommendations to develop micro financing, medium and long-term financing, project financing, and venture capital funds. Several of the recommendations suggested the introduction of new laws in relation to banking, bankruptcy, security interests, and security law. None of the recommendations suggested a change to the current Jordanian policy of banking confidentiality.

Jordan's Banking Law No 28 of 2000 requires full confidentiality of all bank records, other than in certain limited circumstances (Articles 72 to 75). The penalties for violating the provisions in Article 72 or 73 are strong: imprisonment for a period not less than six months, a fine of not less than 10,000 JD and not more than 50,000 JD, or both penalties. Article 23 A of the ITL No 57 of 1985, as amended, also provides for banking confidentiality. It is also stipulated that secrecy of banking operations is not to be divulged.

2.6 Jordan's Approach to DTA Negotiation and Administration

Overall, Jordan's approach to DTA negotiation and administration might best be characterized as ambitious in terms of quantity but not in terms of immediate consequences for Jordan. Its approach is also largely reactive.

Jordan is negotiating many treaties quickly. In the twenty years from 1984 to 2004 Jordan has implemented 17 treaties. In addition, Jordan has signed 12 treaties, half-negotiated six treaties and exchanged proposals with 18 countries (see the Jordan's treaty-partner countries in these four categories in Annex 6). In other words, if all the possible treaties were negotiated and implemented in the next five years, Jordan would have negotiated 53 double tax treaties in just 25 years. By contrast, New Zealand, which is another small, open economy, has just 28 double tax treaties negotiated over more than 40 years.

On the other hand, it is difficult to see immediate beneficial consequences for Jordan from negotiating these treaties. Jordan has only one major base for its income tax: the taxation of income from domestic capital. It is able to administer its tax rules on this income, with or without a double tax treaty. Further, the Jordanian government already relieves Jordanian income tax on most imported capital through its tax incentive program. Finally, Jordanian income tax attempts to tax its residents on their exported capital to a very limited extent, so there is very little help that the treaty partner can offer Jordan in enforcing the Jordanian income tax. The best that can be argued from a Jordanian national perspective is that Jordan's double tax treaties currently provide some certainty of tax treatment to those foreign investors in Jordan who currently are taxed or who may be taxed in the future.

In addition, Jordan's domestic tax law currently does not levy non-resident withholding tax on some payments up to the maximum limit allowed by many of Jordan's double tax treaties (see dividends and interest below) and Jordan's non-resident withholding tax rates in Jordan's ITL on other income are also low:

- no Jordanian withholding tax on a dividend from a Jordanian company to a foreign company (many of Jordan's DTAs allow 10 percent non-resident withholding tax);

- 10 percent Jordanian withholding tax on a royalty payment from a Jordanian company to a foreign company (Article 18 (A) of Jordan's ITL);

- 5 percent Jordanian withholding tax on an interest payment from a Jordanian company to a foreign company (Article 19 (4)(a) of Jordan's ITL; many of Jordan's DTAs allow 10 percent non-resident withholding tax);

- 10 percent Jordanian withholding tax on management fees paid from a Jordanian company to a foreign company (Article 18 (A) of Jordan's ITL).

Finally, Jordan is reactive both in its choice of DTA partners and its use of DTAs. We were told that Jordan had not asked another country to negotiate a double tax treaty. The request had always come from the other country. We also told that Jordan had not asked for tax information from another country under the provisions for information exchange in its double tax treaties. Information requests had, however, come to the Jordanian authorities from their treaty partners.

The 2002 Investor Roadmap of Jordan characterized DTAs with the United States, the European Union and European Free Trade Agreement states as "quick wins" that Jordan should negotiate. Jordan is certainly making "quick" decisions about double tax treaties requested of it. It is much more difficult to characterize Jordan's current DTA program as creating "wins", given that every DTA that Jordan negotiates involves Jordan giving away income tax revenue, accepting responsibility to help one more country administer its tax system and getting little or no help in return, not immediately getting more foreign investment (many countries with which Jordan is negotiating are not likely to be large providers of foreign direct investment to Jordan) and making the task of reforming its international income tax rules more difficult (see sections 5 and 6 below).

3. United States DTA Policy Objectives

3.1 Introduction

Section 3 briefly describes US double tax treaty policy on the key issues of importance to Jordan. Fortunately, the current US position on these issues was recently put on record in testimony by Barbara M. Angus, International Tax Counsel, United States Department of Treasury, to the US Senate Committee on Foreign Relations on 25 February 2004. Ms Angus was appearing before that Committee to recommend, on behalf of the Bush administration, favorable action on the US double tax agreements with the Japan and Sri Lanka. Ms Angus' testimony is reproduced in full in Annex 7.

In addition, the United States is one of the few countries that publishes its Model Treaty. The latest version of the US Model Treaty is dated 1996. In general, it is consistent with the OECD Model Treaty. It does, however, provide more detail on certain articles. It adds more responsibilities, for example, in the area of exchange of information. It also includes additional articles, like the anti-treaty shopping rule.

It is important to emphasize that the US Model Treaty is not the 'bottom line' for the United States in DTA negotiations. In its technical explanation of the US Model Treaty, the US Treasury states:

> *[I]t is unlikely that the United States ever will sign an income tax convention that is identical to the Model.*[17]

The US Treasury also states that the US Model

> *[i]s not intended to represent an ideal United States income tax treaty. Rather, the principal function of the model is to facilitate negotiations by helping the negotiators identify differences between income tax policies in the two countries.*[18]

Further, work on updating the 1996 US Model Treaty is possible in the near future. The staff of the Joint Committee on Taxation believes that the 1996 US Model "is becoming obsolete and is in need of an update."[19] The US Treasury International Tax Counsel has indicated, in her recent testimony to the US Senate Committee on Foreign Relations appended to this report as Appendix 7, that the recent US DTAs with Japan and the United Kingdom are one place to look for possible changes to the US Model Treaty 1996:

> *Significant resources have been devoted in recent years to the negotiation of new tax treaties with Japan and the United Kingdom, two major trade and investment partners for the United States and two of our oldest tax treaties. With the completion of these important negotiations, we believe that would be appropriate to update the US model treaty to reflect our negotiating experiences since 1996. A new model will help facilitate the negotiations we expect to begin in the near future. We look forward to working with the staffs of the Senate Foreign Relations Committee and Joint Committee on Taxation on this project.*

[17] US Treasury, *Technical Explanation of US Model Treaty* (1996) Introduction at paragraph 7.
[18] Ibid, paragraph 6.
[19] Yin, G., *Testimony of the Staff of the Joint Committee on Taxation Before the Senate Committee on Foreign Relations Hearing on the Proposed Tax Treaties with Japan and Sri Lanka*, p. 5.

Ms Angus' testimony in relation to the US double tax treaty with Japan emphasizes the importance that the United State places on bringing its treaties up-to-date with US investment, trade, and income tax policy. Ms Angus points out that the existing US-Japan DTA, which was signed in 1971, "does not reflect the changes in economic relations between the two countries that have taken place over the last 30 years." On the other hand, the fact that the 1971 treaty stayed in place between two of the world's largest economies for 30 years emphasizes the importance of taking a 30-year perspective in developing a country's DTA negotiating positions and in deciding whether to implement a treaty that has been negotiated.

Ms Angus highlights the following key provisions in the new US-Japan treaty, which was ratified by both countries and came effective on 30 March 2004:

It substantially lowers maximum withholding tax rates on interest, royalty and dividend payments, in some cases to zero:

- It has a comprehensive limitation of benefit article designed to stop investors routing income that arises in one country to a person in a second country through either the United States or Japan in order to obtain tax advantages in this new US-Japan treaty;

- It has comprehensive exchange of information provisions, made possible by recent changes in Japanese law.

Ms Angus' testimony in relation to the US double tax treaty with Sri Lanka illustrates the US positions on issues of importance to a developing country, like Jordan. It also illustrates the length of time that can take a developing country to negotiate a DTA with the United States (in this case, nearly 19 years). The proposed DTA with Sri Lanka was signed in 1985 but was not implemented. The US Senate did not act upon it at the time because the proposed DTA was not consistent with changes that were made to the US domestic international tax rules in 1986. The proposed Protocol, signed in 2002, amends the proposed 1985 DTA to reflect changes in US domestic income tax law and US double tax treaty policy.

Ms Angus highlights the following key provisions in the new US-Sri Lanka treaty:

The maximum withholding tax rates on interest, royalty and dividend payments are higher than those allowed in DTAs the United States has with developed countries, like the US-Japan DTA 2004;

- The definition of a 'permanent establishment', which specifies the level of economic activity required for host country taxation, is broader than the definition in the US Model DTA;

- A comprehensive limitation of benefit article designed to deny third country residents the benefits of the treaty is included;

- It has comprehensive exchange of information provisions.

3.2 US Policy on Exchange of Taxpayer Information

The exchange of taxpayer information is the one issue that Ms Angus describes as being 'non-negotiable' in her testimony to the US Senate. This is understandable for a country that asserts its jurisdiction to tax both its residents and its citizens on their worldwide income. Few countries in the world tax their citizens, as well as their residents, on their worldwide income.

The US Treasury International Tax Counsel described US policy on exchange of taxpayer information in her 25 February 2004 testimony, in these terms:

> *A key element of U.S. tax treaties is the provision addressing the exchange of information between the tax authorities. Under tax treaties, the competent authority of one country may request from the other competent authority such information as may be necessary for the proper administration of the country's tax laws; the requested information will be provided subject to strict protections on the confidentiality of taxpayer information. Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program. If a country has bank secrecy rules that would operate to prevent or seriously inhibit the appropriate exchange of information under a tax treaty, we will not conclude a treaty with that country. In fact, information exchange is a matter we raise with the other country before commencement of formal negotiations because it is one of a very few matters that we consider non-negotiable.*

In relation to the most recent DTA that the United States has negotiated with a developing country, the US Treasury International Tax Counsel had this to say:

> *The proposed treaty [between the US and Sri Lanka] includes an exchange of information provision that generally follows the US Model. Under these provisions, Sri Lanka, will provide US tax officials such information as is relevant to carry out the provisions of the treaty and the domestic tax laws of United States. Sri Lanka has confirmed through diplomatic note its ability to obtain and exchange key information relevant for tax purposes. The information that may be exchange includes information held by financial institutions, nominees or persons acting in an agency or fiduciary capacity.*

It is not only the US Executive that has taken a strong line on exchange of information. The US Senate also considers this to be a vital DTA issue. A dispute between Israel and the Senate about the exchange of information requirements in the double tax treaty between Israel and the US caused the Senate to delay approval of the treaty. Eventually, an agreement was struck and the US Senate consented to a protocol to the double tax treaty with Israel, making it possible for the 1975 Israel-US treaty to come into effect in 1995. The agreement also allows congressional tax writing committees and the General Accounting Office access to information exchanged under the treaty.[20]

[20] Turro, J, "Senate Action Paves Way For U.S.-Israel Treaty to Take Effect" *Tax Notes*, 3 October 1994 vol 65 no 1, 37-8. Turro, J, "Senate Approves Six New Tax Treaty Agreements" *Tax Notes*, 29 November 1993 vol 61 no 9, 1038-40.

Clearly, exchange of information and, bank information in particular, will be the crunch issue for a Jordan-US DTA negotiation. In our consultations in Amman, some tax advisers pointed out to us that the United States had entered into DTAs with some other countries in the region without insisting on a specific exchange of bank information provision. They gave the US-Morocco and US-Egypt DTAs as examples. In effect, they were asking why Jordan cannot expect to negotiate a DTA with the United States including the same exchange of information provision that the United States had earlier agreed with Morocco and Egypt. While it is true that DTA negotiations are often driven by what has been accepted in the past, this is not an adequate way of analyzing vital interests, like exchange of information is for both the United States and Jordan. The US-Morocco and US-Egyptian DTAs were negotiated more than 20 years ago. They do not represent current US policy.

Equally, in our consultations in Amman some concern was expressed about Jordan accepting particular obligations in the 1996 US Model Article 26 on exchange of information (EOI), like paragraph 6 set out below:

> *The competent authority of the requested State shall allow representatives of the applicant State to enter the requested State to interview individuals and examine books and records with the consent of the persons subject to examination.*

To paint a fuller, and we hope, more accurate picture of US policy, we have assembled in Annex 9 the text of Article 26 in the 1996 US Model DTA, and a selection of US DTA EOI provisions, including all of the EOI articles in all of the US DTAs with countries in the Middle East and North Africa, the EOI articles in US DTAs with two countries that have a well-known policy of bank confidentiality, as well as EOI articles in very recent US DTAs with a Latin American country and a South Asian country. There is in this selection of US DTAs an historical perspective (1977-2004), a Middle East and North African perspective and a developing country perspective. We have reproduced the text of the EOI article and, in some cases, exchange of notes, memoranda of understanding, protocols, and technical explanations about the EOI provision.

We note from this selection of DTAs, for instance, that paragraph 6 in the US Model (reproduced above) is not included in any of these eight US DTAs: the US DTAs with Morocco, Egypt, Israel, Turkey, Switzerland, Venezuela, Luxembourg, or Sri Lanka.

In determining whether it will seek to negotiate a DTA with the United States, Jordan needs to focus on the EOI provisions in the most recent US DTAs (those with Venezuela and Sri Lanka, for instance, which were signed in 1999 and 2003 respectively) and those with other countries with banking confidentiality policies (Switzerland and Luxembourg, both signed in 1996). Jordan needs to consider, for instance, whether it would agree to exchange of bank information in cases of 'tax fraud', such as Switzerland has (see Appendix 9.7). In that case, "tax fraud" would then be added to the exceptions to banking confidentiality in Articles 72 to 75 of Jordan's Banking Law No 28 of 2000.

Finally, we should note that the interest in strengthening exchange of information requirements in double tax treaties is widely shared among many OECD countries. On 23 July 2004 the OECD announced its latest initiative to strengthen tax information sharing (see appendix 10):

> *The new arrangements are set out in a revised version of Article 26 of the OECD's Model Tax Convention, which covers the exchange of information on tax matters. The provisions of Article 26 are widely accepted as providing the international standard for exchange of information between tax authorities. In its updated version, Article 26 now reflects current practices in many countries as well as an agreement between OECD countries on the ideal standard of access to bank information for tax purposes.*

Of particular interest to Jordan are the changes in relation to the bank information:

> *A new paragraph has been added to ensure that ownership information and information held by banks, financial institutions, nominees, agents and fiduciaries can be exchanged. New paragraph 5 prevents bank secrecy from being used as a basis for refusing to exchange information.*

The new OECD Commentary makes the point that the vast majority of OECD member countries already exchange bank and financial institution information under the previous version of Article 26 and that the addition of paragraph 5 merely reflects current practice. Nevertheless, a small number of OECD countries have made a reservation in respect of paragraph 5. Belgium and Luxembourg reserve the right not to include this paragraph in their conventions. Austria and Switzerland have made a more limited reservation to paragraph 5, both of them being prepared to exchange bank information in certain cases of tax fraud.

3.2.1 Jordanian Bank Secrecy Under the USA Patriot Act

It is necessary to consider the extent to which the recently enacted USA Patriot Act[21]authorizes US government agencies to obtain details of Jordanian bank accounts and account holders. The Act extends executive powers under existing anti-money laundering legislation and intelligence surveillance legislation. The preamble to the Act gives a broad objective: "An Act to deter and punish terrorist acts in the United States and around the world, to enhance law enforcement investigatory tools, and for other purposes."

Section 505 of the Act authorizes the Federal Bureau of Investigation (FBI) to issue "national security letters" to organizations, including financial institutions, phone companies and internet providers, requiring them to disclose information about their customers. All Jordanian banks with operations in the United States would likely be subject to these provisions. Information to be disclosed arguably includes only information held in the United States by the Jordanian bank. However, the FBI would likely seek further information about the customer or transaction held in Jordan.

Title III of the Act comprises the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001. This strengthens record keeping and reporting requirements of financial institutions in the United States and strengthens the ability of the Secretary of the Treasury to seize financial assets. Banking related powers can be summarized as follows:

[21] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA Patriot Act) 2001, Pub. L. No. 107-56, 115 Stat. 272 (2001)

1. Financial institutions subject to the Act include branches of foreign banks, travel agencies, vehicle leasing firms and realtors. The number of institutions that have to report suspicious activity and cash transactions involving more than $10,000 has been expanded. All institutions have to sufficiently identify foreign clients and reply to requests from US Authorities for account information within 120 hours of the request. [Section 319, 321 and 326]

2. Of particular significance for Jordanian banks is the requirement for banks in the United States to apply additional due diligence policies if managing correspondent accounts[22] or private bank accounts[23] for foreign persons, including foreign banks. US authorities may subpoena foreign banks maintaining correspondent accounts in the United States requesting foreign or local records related to the account. [Section 312 and Section 319]

3. If a country, foreign financial institution or transaction is regarded by the US Treasury Department as being of "primary money laundering concern" then the Secretary may apply specific measures to address money laundering concerns. The Secretary has already proposed prohibiting any US financial institution from opening or maintaining a correspondent account with the Commercial Bank of Syria and its subsidiary , the Syrian Lebanese Commercial Bank. Special measures have also been proposed against the country, Nauru. [Section 311]

4. If the foreign bank is an offshore bank or from a country designated as non-cooperative in terms of money laundering by the OECD[24] then banks in the United States shall identify the foreign bank owners, scrutinize the accounts for money laundering, and identify third country banks maintaining correspondent accounts for the foreign bank. [Section 312]

5. Finally, the US administration is urged to enter into agreements with countries to ensure that foreign financial institutions report details of transactions relating to terrorist organizations or money laundering. [Section 330]

In summary, although the Patriot Act expands the power of US authorities to obtain financial information held within the United States, banking records held exclusively in a foreign country are likely to remain relatively inaccessible. Jordanian banks operating in the United States can be requested to provide details of their accounts held by Jordanians, however, only the Arab Bank operates a branch in the United States. Remaining Jordanian banks that only maintain a correspondent account with a bank in the United States are subject to requests for information relating to use of the account. It does not appear that Jordanian banks need provide information on their clients affairs if unrelated to the operation of the bank's correspondent accounts in the United States.

[22] A correspondent account is an account established by a US financial institution for a foreign bank to receive deposits, make payments or handle other financial operations relating to the foreign bank.
[23] Accounts holding more than one million dollars and managed by an intermediary.
[24] There are six countries currently listed as non-cooperative by the OECD: Cook Islands, Indonesia, Myanmar, Nauru, Nigeria and the Philippines. Egypt and Lebanon have been removed from the list in the last two years.

3.3 US Policy on Foreign Country Tax Incentives

In the past, the United States has granted special tax incentives to encourage investment with developing countries, especially in Latin America (see, for example, sec. 936 IRC in 2000 in relation to Puerto Rico). By comparing Japanese and American investment patterns, a prominent American tax economist, Professor James Hines Jr., has produced some evidence suggesting that tax sparing does influence the level and location of FDI as well as foreign governments' willingness to offer tax concessions.[25] Other academic commentators argue that the United States should include tax sparing provisions in its treaties, among other reasons, to increase US FDI in developing countries and enlarge the number of US DTAs with developing countries.[26]

US DTA policy, on the other hand, has been opposed to offering tax sparing the developing countries since the late 1950s. The most that the United States has been prepared to do in a DTA is to undertake "to review its position should the Senate reconsider its decision on this matter." (See text of Note of Exchange from the Moroccan Government to the US Government, set out in appendix 8.)

A former US International Tax Counsel has been quite forthright in expressing US policy:

> *We have no intention of resurrecting [special tax benefits designed to encourage investment and trade with developing countries], primarily because they do not serve their intended purpose, but also because they are inconsistent with our longstanding tax policy favoring capital export neutrality, which is the best way to allocate capital across the globe. The US also believes, and the economic evidence supports us, that tax holidays and related tax sparing treaty provisions are counterproductive. We believe that other assistance, such as providing sound economic advice through private, governmental and intergovernmental organizations, provide much more productive routes to growth.* [27]

It appears that the US view on the issue of tax sparing is now more widely shared among OECD countries. Appendix 8 contains the recommendations from a 1998 OECD study on the subject. The report identifies three major concerns with the usefulness of OECD Members granting tax sparing relief. The first is the potential offered by tax sparing for abuse of tax systems and tax treaties. Examples of the attempted abuse of tax sparing provisions in New Zealand's and Australia's DTAs are set out in Appendix 12.1 to this report. The second concern is about how effective tax sparing is as a form of economic aid to developing countries. The third is a general concern about the ways in which tax sparing may encourage countries to use tax incentive programs.

3.4 US Policy on Withholding Rates of Tax

It seems clear from US recent treaties with developed countries, like the United Kingdom, Japan and Australia, that US DTA policy is now to seek substantial reduction of source-

[25] Hines, J R, *"Tax Sparing" and Direct Investment in Developing Countries*, NBER Working Paper No 6728, September 1998.
[26] Laurey, D, *Re-examining US Tax Sparing Policy With Developing Countries: The Merits of Falling In Line With International Norms*, (2000) 20 Virginia Tax Review 467.

[27] Guttentag, J., *Emerging Issues in Taxing Business in a Global Economy*, SG/APEC/CFA(96)4, (1996) p. 8.

country withholding taxes, sometimes down to zero. This is especially so on royalty payments but also on certain dividend and interest payments.

US treaty policy in respect of developing countries, like Jordan, is more flexible, being prepared to accommodate some higher withholding rates of tax as a first step towards eventually reducing these taxes in the future (see the full text of the Angus testimony in appendix 7):

> *Lesser developed and newly emerging economies, for which capital and trade flows with the United States are often disproportionate or virtually one-way, may be reluctant to agree to the reductions in source country withholding taxes preferred by the United States because of concerns about the short-term effects on their tax revenues. These countries have two somewhat conflicting objectives. They need to reduce barriers to investment, which is the engine of development and growth, and reducing source-country withholding taxes reduces a significant barrier to inward investment. On the other hand, reductions in source country withholding taxes may reduce tax revenues in the short-term. Because this necessarily involves the other country's judgment regarding the level of withholding taxes that will best balance these two objectives, our tax treaties with developing countries often provide for higher maximum rates of source-country tax than is the US preferred position. Such a treaty nevertheless provides benefits to taxpayers by establishing a stable framework for taxation. Moreover, having an agreement in place makes it easier to agree to further reductions in source-country withholding taxes in the future.*

3.5 US Policy on Limiting Who Can Benefit from a US Treaty

Having effective anti-treaty-shopping provisions is another non-negotiable position of the US (see the full text of the Angus testimony in appendix 7):

> *The U.S. commitment to including comprehensive provisions designed to prevent "treaty shopping" in all of our tax treaties is one of the keys to improving our overall treaty network. Our tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis. The reductions in source-country taxes agreed to in a particular treaty mean that U.S. persons pay less tax to that country on income from their investments there and residents of that country pay less U.S. tax on income from their investments in the United States. Those reductions and benefits are not intended to flow to residents of a third country. If third-country residents can exploit one of our treaties to secure reductions in U.S. tax, the benefits would flow only in one direction. Such use of treaties is not consistent with the balance of the deal negotiated. Moreover, preventing this exploitation of our treaties is critical to ensuring that the third country will sit down at the table with us to negotiate on a reciprocal basis, so that we can secure for U.S. persons the benefits of reductions in source-country tax on their investments in that country.*

Some countries have not been as concerned about limiting the benefit of their treaties with the United States to US residents who invest in their country. Some consider that they would not be able to implement these complex 'limitation of benefit' clauses. As the main US concern is with foreign investment into the United States, the United States has been prepared in the past to agree to a limitation of benefit (LOB) clause that is very

detailed in relation to foreign investment into the United States, where it is the Untied States that will be enforcing them, but not so detailed in relation to US investment into the foreign country, where it is the foreign country that will be enforcing the clause. One such treaty is the US-Canada DTA 1980. The LOB clause in that treaty is reproduced in Appendix 11. Paragraph 7 of that LOB clause reads:

> *It is understood that the fact that the preceding provisions of this Article apply only for the purposes of the application of the Convention by the United States shall not be construed as restricting in any manner the right of a Contracting State to deny benefits under the Convention where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Convention.*

This would be an appropriate solution for Jordan too. It would protect Jordan's right to deny the benefits of the treaty where an objective case existed that the treaty provisions were being abused without burdening Jordan's tax administration.

3.6 US Approach to DTAs

To conclude, the current 1996 US Model DTA is not an ideal US DTA but is intended to identify the issues for negotiation. That 1996 US Model DTA is due to be reviewed by Congress and Treasury, as it is out-of-date. Recent US treaties with the United Kingdom and Japan provide a better guide to current US DTA policy. The 2004 US DTA with Sri Lanka provides a good guide to current US DTA policy towards developing countries, like Jordan.

The US negotiates DTAs to assist it collect tax on its three income tax bases:

- US residents;
- US citizens; and,
- to a lesser extent, US local source income (US domestic tax law is the prime means of collecting tax on this base).

US tax law imposes high withholding taxes on cross-border investment that the United States is prepared to reduce only in a DTA.

The US Treasury proactively sets its DTA negotiating priorities. Its first priority is to renegotiate out-of-date DTAs, starting with those with its key investment and trade partners. Its second priority is to negotiate treaties that are likely to provide the greatest economic benefits to US and foreign-based businesses and individuals. Its third priority is to negotiate treaties with countries that have the potential to be significant trading partners.[28]

The US Treasury negotiates a limited number of treaties slowly, while the US Senate approves negotiated with treaties only where US national and business interests are advanced. In 65 years, the US has negotiated 63 treaties (1939-2004). This is in marked contrast to Jordan. In the twenty years from 1984 to 2004 Jordan has implemented 17 treaties and if all the possible treaties on Jordan's treaty program were negotiated and implemented in the next five years, Jordan would have negotiated 53 double tax treaties

[28]Ibid, p. 4.

in just 25 years. The US is currently negotiating six treaties (Bangladesh, Canada, Chile, Hungary, Iceland and Korea).

4. Tax Issues for Cross-Border Investment between Jordan and the United States

4.1 Introduction

Jordan's income tax law and administration is the major cause of tax issues for cross-border investment between the United States and Jordan, according to most business people and professionals we consulted. The US income tax system also raises some issues for cross-border investment between the United States and Jordan but these issues are generally seen as being of lesser importance.

4.1.1 Jordanian Investment in the United States

For Jordanian investment in the United States, this response was understandable. The international income tax issues identified in section 4.2 below are merely a subset of the general income tax issues that Jordanians face, whether they work or invest at home or overseas.

Despite some reform, like lowering income tax rates over the last ten years, Jordan's income tax policy, law and administration continues to be criticized regularly, for example in *Jordan Vision 2020*, the investor roadmaps of Jordan (1998 and 2002) and reports by international organizations, like the IMF and the World Bank.[29]

'Improving the direct tax system' was identified as one of three significant fiscal challenges over the medium term for Jordan by the IMF in a report released in September 2004. The other two were 'oil price vulnerability and grant dependence.'[30] The IMF report added:

> In order to harness Jordan's greater revenue potential, the mission urged the authorities to overhaul the income tax system in a more equitable and efficient manner.[31]

4.1.2 US Investment in Jordan

Most US investors in Jordan we consulted did not consider that they had tax issues relating to their cross-border investment, presumably because they currently enjoy a tax holiday in Jordan, and thus have little or no contact with the Jordanian income tax system, and they thought that a Jordan-US double tax treaty would make little difference.

Some US investors, however, identified Jordan's income tax system as the main cause of the cross-border tax issues they face. This response was a little surprising. With most US direct investment in Jordan currently enjoying a tax holiday in Jordan, it might have been expected that all US direct investors in Jordan would have little or no contact with the

[29] The World Bank, *Jordan: Development Policy Review: A Reforming State in a Volatile Region Report No. 24425-JO*, November 5, 2002, p, 27.
[30] International Monetary Fund, *Jordan: Third Review Under the Stand-By Arrangement; and Press Release on the Executive Board Discussion*, September 2004, IMF Country Report No. 04/287 at p 5 & 15, available at <http://www.imf.org/external/pubs/ft/scr/2004/cr04287.pdf>.
[31] Ibid, p. 15.

Jordanian income tax system and that none of them would report any tax issues caused by Jordan's income tax system.

In fact, US direct investment in Jordan only has no contact with the Jordanian income tax system if it has a very simple ownership and business structure. Below, we use simple illustrations to show how US direct investment in Jordan can have contact and issues with the Jordanian income tax system, even if it enjoys an income tax holiday on its active business in Jordan.

Figure 1 describes a simple ownership and investment structure for US direct investment in Jordan. Investors using this simple structure should not face issues with Jordan's income tax system. Figure 2 describes a slightly more complicated investment structure involving a joint US-Jordan owned venture in Jordan. The joint venture has US operations. One reason for the joint venture in Jordan owning a US company may be to distribute joint-venture production in the United States. Equally, there may be other commercial or regulatory reasons for a Jordanian company, which is wholly or partly owned offshore, setting up an associated production facility in the United States.

We have argued earlier that the appropriate time horizon to use in devising double tax treaty policy is the typical life of a double tax treaty: 20 or 30 years. If Jordan were to become a regional centre for certain types of foreign investment in the Middle East and North Africa region at some time in the next 20 or 30 years, these 'sandwich' structures with a Jordanian company sitting between foreign investors and their investment in third countries in the region, would become more common. This slightly more complicated investment and ownership structure for investment by a Jordanian company faces issues with Jordan's current income tax system of the type identified in section 4.2 below.

In section 4.2, we identify and discuss some of the tax issues for US-Jordan investment created by Jordanian income tax policy, law and administration. Section 4.3 then identifies tax issues for this cross-border investment created by the US income tax policy, law and administration. Section 4.4 briefly considers in what circumstances an international income tax 'issue' that is raised by the private sector can, from a national perspective, be considered a 'barrier' to cross-border investment. Section 4.5 contains conclusions.

4.1.3 US Investment Scenario 1: Simple Structure: No Contact with Jordan's Tax System

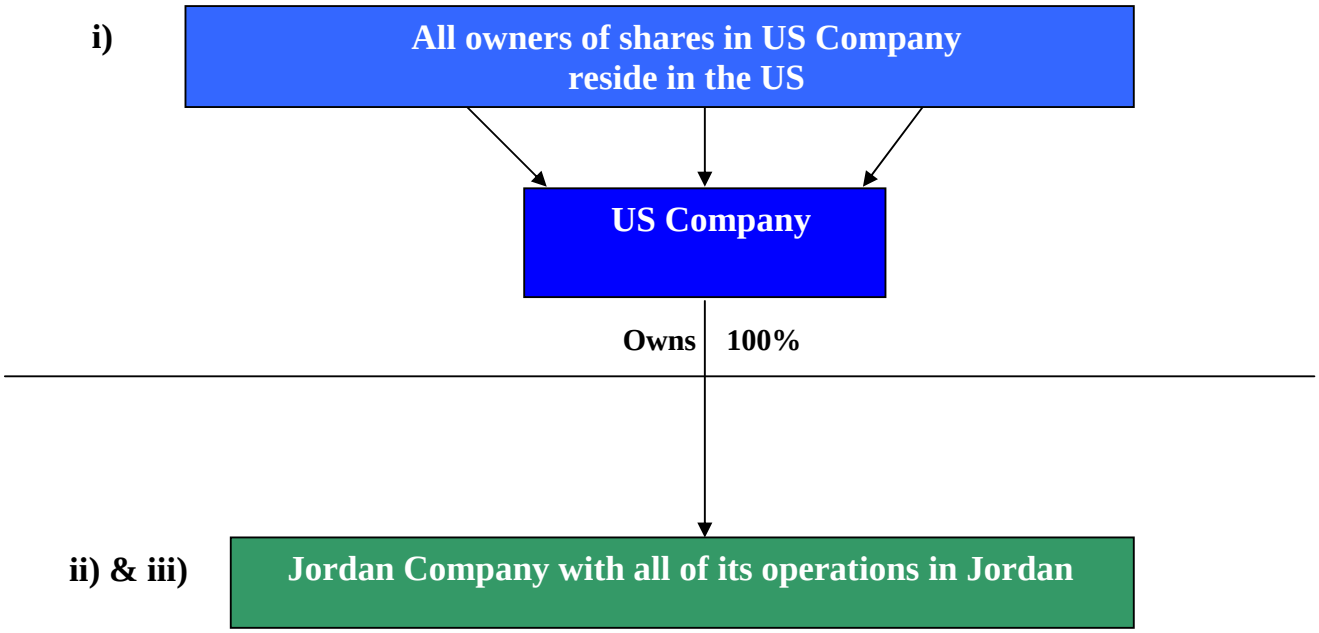
US direct investment in Jordan only has no contact with the Jordanian income tax system under current law if it has a very simple ownership and a business structure, such as in Figure 1 below:

i. The US direct investor in Jordan (US company below) is wholly owned by US (or other foreign) residents;

ii. Jordan company enjoys a complete holiday from all Jordanian tax on its operations in Jordan; and,

iii. Jordan company only operates in Jordan with no operations offshore, for instance in the United States.

Figure 1



4.1.4 US Investment Scenario 2: More Complex Structure: Contact with Jordan's Tax System

Where US direct investment in Jordan has a slightly more complicated ownership and business structure, as in Figure 2 below, US direct investors in Jordan would have extensive contact with the present inadequacies of the Jordanian income tax system and that contact may create difficulties, even allowing for tax planning opportunities available for cross-border investors to reduce the cost of earning income in a country and repatriating profits, because:

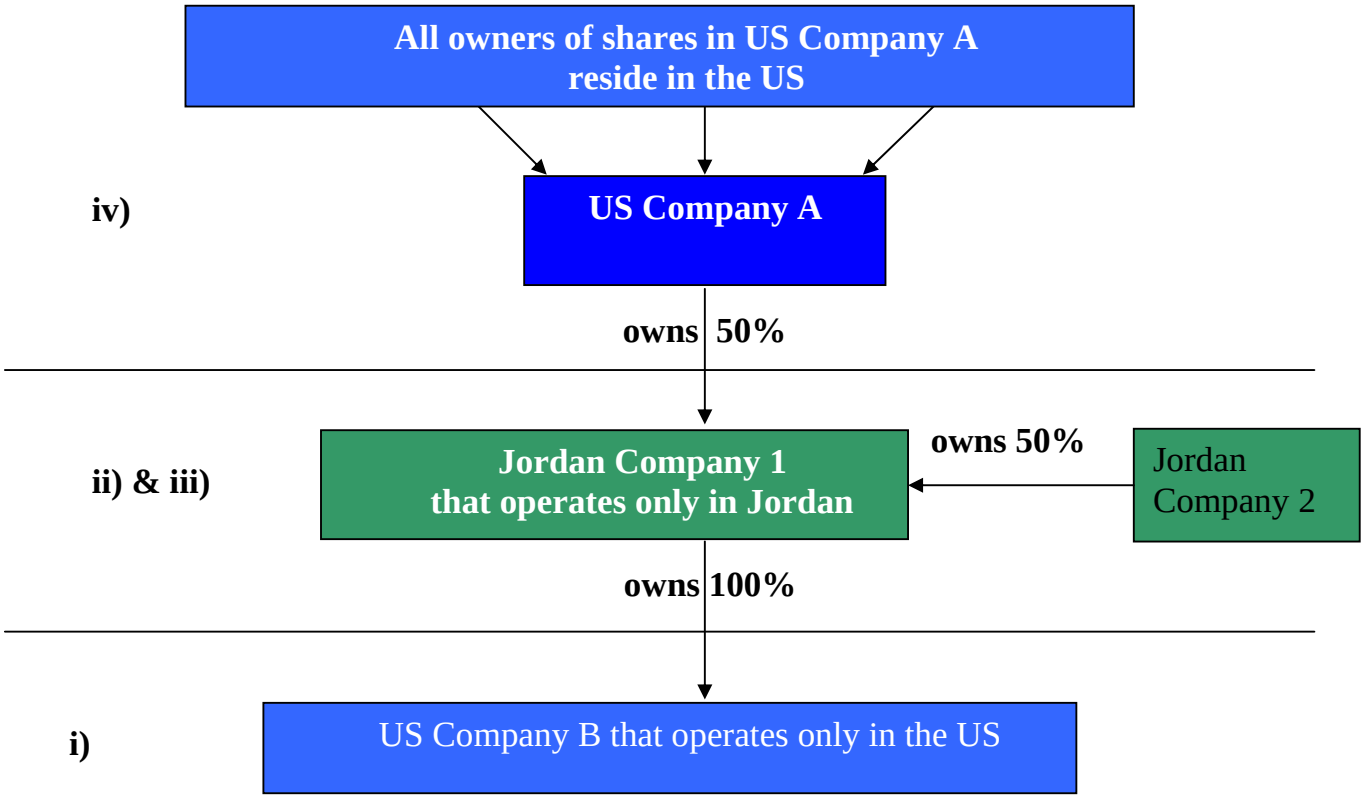
1. Jordan Company 1 must report and pay Jordanian income tax on 100 percent of its income from US Company B, calculated according to Jordanian ITL;

2. Jordan Company 1 must also report and pay Jordanian income tax on 100 percent of its income from its Jordanian operations, calculated according to Jordanian ITL, although with a 50 percent US direct investor it may be eligible for some Jordanian tax incentives for its operations in Jordan;

3. Jordan Company 2 must report and pay Jordanian income tax on its 50 percent share of the income of Jordan Company 1, calculated according to Jordanian ITL (profits from US Company B; and, from the Jordanian operations of Jordan Company 1, unless Jordanian tax incentives apply); and,

4. US Company A is entitled to its 50 percent share of the income of Jordan Company 1, which Jordan Company 1 has calculated and reported according to Jordanian ITL, (profits from US Company B: and, from the Jordanian operations of Jordan Company 1, unless Jordanian tax incentives apply).

Figure 2



4.2 Issues Created by Jordan's Income Tax

4.2.1 Jordanian Income Tax Policy and Law

In the course of consultation with government officials, business people and professional advisers, it became clear that the lack of a clear, consistent and comprehensive government policy on Jordan's income tax was creating uncertainty for some investors. In many cases, the lack of clear and consistent policy will be the cause of the unclear and inadequate international tax rules in Jordan's legislation. The drafting of these rules often leaves issues unclear, is sometimes based on a flawed concept, is inconsistent in the way that it treated a common issue and deals inadequately with all the issues involved in taxing certain income. The most recent IMF mission report on Jordan notes, "The income tax legislation has been strengthened, albeit to a limited extent."[32] It does not elaborate. We were unable to identify such improvements in Jordan's international income tax rules.

With no clear, consistent and comprehensive government income tax policy and unclear and inadequate legislation, it is inevitable that the various participants in a tax system will develop different views on what the law and government income tax policy is on an issue. Naturally, the position taken by each participant in a tax system will be colored by whether they are a tax official, a tax adviser or an investor.

[32] Ibid., p. 34.

In this section, we identify and briefly discuss some of the important income tax policy and law issues that were raised in our meetings with government officials, business people and professional advisers.

Key issue: To what extent does Jordan tax worldwide income?

One key issue for this report on the benefits of a double tax treaty with the United States is the extent to which Jordan's income tax is still largely territorial and, conversely, to what extent does it now seek to tax Jordan's residents on their worldwide income. Double tax treaties are most useful to countries that tax their residents on a worldwide basis.

As this is the most fundamental international tax policy issue, it is essential that government policy on it is crystal clear. Each time we discussed the extent to which Jordan's income tax was territorial or worldwide in its scope with a different group of tax experts or investors, we were given a different answer.

Unfortunately, it does not appear that there is a clear statement of government policy on this issue. Further, the drafting of the two exceptions to territorial taxation, in Article 3 (B) of the Jordan ITL, lacks clarity and does not deal adequately with many issues associated with taxing residents on their offshore income. In addition, the drafting of Article 3 (B)(1) is based on a flawed concept.

We first briefly sketch the history of Article 3B. We then identify some of the law and policy issues arising from the way that the Article is conceived and drafted.

History of Jordan's two worldwide taxation provisions

Before 1985: Before 1985, Jordan taxed only income that was earned from economic activity that took place inside the borders of the Kingdom. The opening words in Article 3 that defined 'sources of income' for the purposes of the Jordanian ITL stated:

> "Income accrued or earned in the Kingdom from the following sources by any person shall be subject to tax: 1) Profits for gains … etc

In other words, Jordan taxed income on a territorial basis. If income was earned within the territory of Jordan and belonged to one of the categories of income specified in Article 3, Jordan taxed it. If income was earned outside Jordan, no matter what category of income it belonged to, Jordan would not tax it.

1985: In 1985, Jordan enacted an exception to its general policy of taxing income only on a territorial basis. This exception had very limited application. It taxed on a worldwide basis income of one type only, when it was earned by a one general category of enterprise only: interests and commissions that were earned by financial and insurance companies and that arose from their money and deposits in Jordan. Article 3 (B) read:

> Interests and commissions earned outside the Kingdom by any licensed bank, financial company, money changers or insurance company shall be subject to tax after this law is effective, and that is a rising from its money and deposits in the Kingdom.

1989 & 1992: The next two amendments to Article 3 (B) retained the type-of-income restriction to 'interests and commissions' but broadened the type of company liable to pay

income on this type of income to all ordinary companies resident in the Kingdom (temporary amendment in 1989; and, a similar permanent amendment in 1992).

The 1992 amendment also added a provision taxing income earned by Jordanian persons outside Jordan that resulted from investing capital realized out of his or her money and deposits from the Kingdom. This amendment seems designed to tax dividends from shares in overseas companies where the shares were bought from money and deposits from Jordan. The formula for taxing this income shows that the measure was designed to put Jordanian persons investing in Jordan's banks and investing offshore on a similar footing. The income was to be calculated according to the average percentage of interest on deposits prevailing in the Kingdom during the year.

1995 to present: Finally, the current law in paragraph (B) of Article 3 was enacted in 1995. It reads:

> 1) All incomes, including interests, commissions, investment returns, profits of trading in currencies, valuable metals and securities which are realized outside the Kingdom by any Jordanian or resident and which are arising from his funds and deposits inside the Kingdom shall be taxable.
> Branches of Jordanian companies operating abroad shall not be subject to this clause.
> The income of a non-Jordanian which is realized abroad from the investment of his foreign capital, returns, profits and the yields of liquidation of his investment or sale of his project or share or stocks after moving them out of the Kingdom according to the provisions of the Encouragement Of Investment Law or any other effective legislation in the Kingdom, shall not also be subject to taxation under this clause.
>
> 2) (20 percent) of the net income, after deducting the foreign income tax, of the Jordanian companies branches operating outside of the Kingdom as declared in their final accounts which are certified by an external auditor shall be taxable.
> In all cases, the net amount resulting from applying that percentage shall be considered a taxable income to the company and shall be taxed at the rate for companies as stipulated in clause (2) of paragraph (B) of Article (16) of this law and no amount or portion of it may be deducted for any reason.
>
> 3) If the taxpayer is that company, income provided for in clause (1) of this paragraph, shall not be taxed again under clause (2) of this paragraph.
>
> 4) The provisions of article (7) of this law shall not apply to the taxable income under this paragraph.
>
> 5) If a loss is incurred at any one year and to any person who is subject to the provisions of clauses (1 & 2) of this paragraph, it will be deducted from the income in each clause separately, up to the limits of such income. The balance, if any, shall be carried forward to the next year and so on up to six years after the year in which it was incurred and shall be deducted from the taxable income of that income, provided that the taxpayer maintains due and proper accounts.
>
> 6) The provisions of paragraph (B) of the Third Article shall be applicable to any Jordanian even if he holds another nationality, in addition to his Jordanian one.

We list below some key policy and legal issues arising from the lack of clarity in the drafting of Article 3 (B), the flawed concept it is based on and the inadequate way that it deals with many associated issues. We consider each of the two main operational clauses in Article 3 (B) separately: first clause (1) and, then, clause (2).

To what extent does Article 3 (B)(1) tax worldwide income?

The key conceptual issue with Article 3 (B)(1) is that it ignores the fungibility of money. It assumes that some units of currencies are different from other units of that same currency and can be traced from a bank account in Jordan through many transactions to a particular investment today. Unfortunately, each unit of currency does not have an identifying label that it carries and transfers to a foreign unit of currency when it is exchanged and so on through tens, or maybe even hundreds, of transactions until an investment today.

Money is fungible. One JD is completely interchangeable with another. Further, Jordanians can freely change JD into foreign currencies. One unit of a foreign currency is completely interchangeable with another unit of that foreign currency, or a unit of a third foreign currency. It is never good tax policy to treat complete substitutes differently. If tax law attempts to do so, it must provide tax administrators, tax advisers and taxpayers with good guidance by adding technical rules to divide items of profit artificially into two groups: one that is taxable and one that is not. Further, tax rule makers must be prepared to amend rules that draw arbitrary lines frequently, as tax advisers and investors will inevitably find new ways around them.

Unfortunately, Article 3 (B)(1) both ignores the fungibility of money and fails to provide a set of technical legal rules that at least attempt to draw lines that are as defensible as possible in the real world.

There was no agreement amongst the tax officials, tax advisers and businesspeople consulted about how Article 3 (B)(1) applied in circumstances such as those below:

1. Jordanian Company (JCo) pays $10 million to buy a 40 percent stake in US Company (USCo);

2. JCo uses funds from the following sources to pay for its stake in USCo:

    a) $1 million from JCo's bank account in a Jordanian bank in Amman, which JCo argues are retained earnings from its operations in Egypt;

    b) $2 million from the French bank account in Paris of JCo's subsidiary in France, which JCo argues are retained earnings from its operations in Europe;

    c) $3 million from JCo's bank account in a Jordanian bank in Amman, which JCo argues is capital subscribed by investors (at the time of subscription, Jordanian residents controlled 70 percent of the ordinary share capital of JCo but at the time JCo bought USCo Jordanian investors merely controlled 40 percent of the ordinary share capital of JCo);

    d) $4 million borrowed from a US Bank by JCo, with JCo guaranteeing repayment of that loan.

In the absence of tax rules that specify how JCo identifies which of the four sources of funding in 2 (a) to (d) above 'arise from funds and deposits inside the Kingdom', it was

understandable that there was such a wide divergence of views amongst officials, advisers and business people consulted about what is taxable under Article 3 (B)(1).

Does Article 3 (B)(1) tax income as it is earned or only on repatriation of income?

We now add three more facts to the scenario described immediately above:

3. In 2003 JCo's share of the gross income of USCo is US$8 million;

4. In 2003 JCo's share of the net income of USCo, after expenses calculated according to US income tax rules, is US$4 million;

5. In 2003 USCo pays JCo a dividend of US$100,000.

The next question on which there was major disagreement among those consulted concerns what is taxed under Article 3 (B)(1).

Some we consulted argued that Article 3 (B)(1) would tax JCo in 2003 on a proportion of the dividend income it received from USCo of $100,000 only. What proportion of the dividend was taxable to JCo in 2003 depended on the answer to the question above about which sources of funding of the purchase of USCo could be said to be arise 'from [JCo's] funds and deposits inside the Kingdom' (see discussion above).

Others we consulted argued that Article 3 (B)(1) taxed JCo on its share of the net income of USCo after expenses calculated according to foreign tax rules (US$4 million) as USCo earned the income, year by year, irrespective of whether any of it was repatriated to JCo in the form of a dividend, for example. On the face of clause (1), this interpretation seems difficult to sustain as clause (1) specifies that it applies to income "realized outside the Kingdom by any Jordanian or resident". In this set of facts, it is USCo, rather than JCo, that 'realizes' USCo's company income outside the Kingdom. On the other hand, the clause (5) references to losses incurred under clause (1) make no sense if clause (1) refers only to distributions, like dividends. It is not possible to make a 'loss' in relation to the receipt of dividends only. A company does not make a 'loss' when it does not receive dividends.

To conclude, there is significant disagreement about whether Article 3 (B)(1) constitutes a relatively minor legal exception to Jordan's territorial tax system (taxing a small proportion of distributions to Jordanian residents at one extreme) or whether it constitutes a significant legal exception to Jordan's territorial tax system (taxing a large proportion of income earned offshore, as it is earned).

In practice, most people consulted confirmed that few individual Jordanians are reporting any income under Article 3 (B)(1). They pointed out how harsh the rules were, giving no credit for foreign taxes, and not allowing any Jordanian expenses to be deducted against this income. Some people confirmed that some public companies were paying tax under this clause on a proportion of distributions only (the narrow interpretation).

Others stated that where a Jordanian public company owned less than 50 percent of a foreign company and Jordan had no double tax treaty with the country in which the foreign company was resident, some public companies are paying Jordanian tax at 25

percent on their share of the foreign company's income, as it was earned, with no foreign tax credit and no allowance for expenses incurred by the Jordanian Company, like the interest expense incurred in funding the foreign investment. This is a particularly harsh treatment of foreign investment. It is one cause of the pressure on the Jordanian Government to conclude more double tax treaties than are necessary so that this income can be exempted from Jordanian income tax under the double tax treaty exemption in Article 7 (B)(7).

At the beginning of this section 4, Figure 2 described a slightly more complicated investment structure involving a joint US-Jordan owned venture in Jordan that had US operations. We pointed out that if Jordan were to become a regional centre for certain types of foreign investment in the Middle East and North Africa region at some time in the next 20 or 30 years, these 'sandwich' structures with a Jordanian company sitting between foreign investors and their investment in third countries in the region, would become more common. The uncertainty over the meaning of Article 3 (B)(1) and the harsh way that it is currently being interpreted in some cases poses tax issues for these 'sandwich' structures. In addition, the inadequate ways that Article 3 (B) currently deals with other issues involved in taxing offshore income (see the section below entitled 'Other international income tax issues in Jordan's domestic rules') simply compound the issue. We can envisage some scenarios in which it might be advantageous for a company group with a sandwich structure to restructure itself so that its head office, and maybe some of its operations, move offshore.

To what extent does Article 3 (B)(2) tax worldwide income?

In contrast to Article 3 (B)(1), which on one interpretation is severe, Article 3 (B)(2) is a concessional regime in two respects:

1. First, the effective Jordanian tax rate clause (2) imposes is just 7 percent on the net income[33] of an offshore branch of a Jordanian company, rather than 25 percent on the gross income of other Jordanians investing offshore, on one interpretation of Article 3 (B)(1);

2. Secondly, clause (2) taxes on the basis of financial accounts. Article 3 (B)(2) taxes net income of the "branches of Jordanian companies operating outside the Kingdom as declared in their final accounts which are certified by an external auditor". Article 3 (B)(2) thus relies on financial accounting standards.

In fact, financial accounting standards can provide choices to taxpayers that allow them to select how much tax they pay. Good tax policy and law should not give choices like this to taxpayers.

International accounting standards, for example, give some discretion to apply either the equity or cost method of accounting for investment in subsidiaries, jointly controlled entities and associates. To the extent that companies use the equity method to account for their interest in subsidiaries, jointly controlled entities and associates, their accounts will reflect their share of the net profit or loss of the entity. To the extent that companies are

[33] In all cases, it is the 35% tax rate in Article 16 (B)(2) multiplied by 20% of the net income after deducting foreign income tax – 35% x 20% = 7%. See Article 3 (B)(2).

able and willing to choose the cost method to account for their interest in subsidiaries, jointly controlled entities and associates, they will book profits in their accounts only when they have received a distribution.

A second way that international accounting standards can be used to reduce income declared in the financial accounts of a particular company in a group is to transfer products out of the company to another company in the consolidated group, which for accounting purposes will be treated as the transfer of inventory and which is eliminated on consolidation (not as a sale, on which there should be a profit).

On the other hand, there are some harsh features common to both Article 3 (B)(1) and Article 3 (B)(2). A Jordanian company is not allowed to offset profits made in some foreign branches against losses made in its other foreign branches, according to Article 3 (B)(5).

To conclude, given the concessional nature of Article 3 (B)(2) compared to Article 3 (B)(1) and that one or other would apply to them, it is inevitable that Jordanian taxpayers try to come within the purview of Article 3 (B)(2). We understand that the practice has developed among tax assessors to allow Jordanian companies owning more than 50 percent of an offshore company to report their share of the offshore company's income under Article 3 (B)(2), rather than under Article 3 (B)(1). Jordanian companies owning 50 percent or less of an offshore company, however, must still report their share of the offshore company's income under Article 3 (B)(1).

Other international income tax issues in Jordan's domestic rules:

Other issues in relation to Jordan's domestic international tax rules that can discourage cross-border trade and investment or erode Jordan's income tax base include:

- The drafting of Jordanian income tax law creates uncertainty and arbitrary results for different taxpayers because it is too brief and vague and has too few definitions of key terms to make its meaning clear. These are just four of many possible examples:

    - The question whether a Jordanian investing overseas is taxed at 7 percent of net income or 25 percent of either gross income or distributions (another uncertainty) turns on the definition of the word 'branches' in Article 3 (B)(1) and (2). The word 'branches' is not defined in the ITL and appears to be given different interpretations by different tax assessors;

    - The meaning of a key expression in Jordanian income tax law, 'the gross income', is unclear. "The gross income" is supposedly defined in Article 2 as "the total taxpayer income from each taxable source of income according to the provisions of this law". Does 'the gross income' mean 'gross revenues' (no expenses taken into account) or 'gross profits' (expenses taken into account)?

    - There are no rules dealing with how to allocate head office expenses to the various branches of a company. As a result, it is unclear whether head office expenses should be allocated according to the services rendered by the head office to each branch of a company or whether those expenses should be allocated according to a formula, like a percentage of profits or sales;

  - Where equipment or machinery used in a business is rendered unusable, what is the 'cost of equipment or machinery replaced' in the formula in see Article 9 (I)?

- Jordan does not provide a credit for foreign taxes on foreign income that Jordan taxes under Article 3 (B)(1) or (2);

- The way that Jordan implements double tax treaties by legislating a blanket exemption from income tax for "the income included in agreements on preventing double taxation included by the government in as much as stipulated by these agreements" in Article 7 (B)(7) provides a huge incentive for taxpayers to lobby the Jordanian government to negotiate more double tax agreements than is necessary. Once a double tax agreement has been implemented between Jordan and a country, the Jordanian investor in that country no longer needs to report under Article 3 (B)(1) or Article 3 (B)(2), for instance, any income that is covered in that agreement.

- Double tax treaties are not published with an explanation of each of the treaties produced by the Jordanian Government;

- Taxpayers may not pool income and losses (i.e., Article 3 (B)(5) requires that the losses incurred offshore must be segregated and carried forward to be offset against income from that investment in the following 6 years in a set of proper accounts. The loss cannot be offset against net income made by the taxpayer on other investments offshore);

- Article 3 (B)(5) continues to restrict the carry forward of losses under Article 3 to a period of six years, when the general income tax loss rules in Article 10 have been amended to allow indefinite carry forward of losses;

- Article 15F of the ITL, which may be used in transfer pricing disputes, provides no rules for implementing the reassessment. It simply states that, "[a]ny artificial or fictitious act of disposal shall be disregarded and tax shall be assessed on the concerned taxpayer as if there is no such an act";

- Company groups cannot consolidate their individual company tax accounts into one consolidated income tax return;

- The different Jordanian withholding tax rates on payments made from Jordan to a nonresident encourage foreign MNEs investing in Jordan to recharacterize their cross-border payments to associated offshore companies so that they pay no or less tax in Jordan:

  - no Jordanian withholding tax on a dividend from a Jordanian company to a foreign company (many of Jordan's DTAs allow 10 percent non-resident withholding tax);

  - 10 percent Jordanian withholding tax on a royalty payment from a Jordanian company to a foreign company (Article 18 (A) of Jordan's ITL);

- 5 percent Jordanian withholding tax on an interest payment from a Jordanian company to a foreign company (Article 19 (4)(a) of Jordan's ITL; many of Jordan's DTAs allow 10 percent non-resident withholding tax);

- 10 percent Jordanian withholding tax on management fees paid from a Jordanian company to a foreign company (Article 18 (A) of Jordan's ITL).

- Article 18 of the ITL requires every person, on paying income, to deduct 10 percent non-resident withholding tax from 'income which is not exempted from income tax'. If a person does not do that, they will be unable to claim a deduction for the expense. There is no definition of what non-resident income is exempted from Jordan's income tax for the purposes of Article 18. Is a payment of income by a Jordanian to a non-resident exempt under this Article according to where the work is executed, where the contract is signed, where the invoice is issued or where the income is collected?

- Under a very broad power in Article 32B, the Director of the Income Tax Department has been issuing decisions imposing fixed annual lump sum taxes on many categories of taxpayers. These are final taxes on gross amounts that take no account of expenses. To the extent that these gross levies are imposed "in lieu of a tax on income … generally imposed by Jordan, are taxes (compulsory payments) and the tax is not a 'soak-up tax' (liability for this tax is dependent on the availability of a foreign tax credit in the United States, for example), these gross fixed taxes should currently be creditable as 'income taxes' in the United States under US domestic law (see Bittker para 72.4.5 on pp.72-26 to 72-29).

4.2.2 Jordanian Income Tax Administration

Changes are beginning to be made to the tax administration of Jordan's income tax. The most recent IMF mission report notes, "[t]o improve tax administration, a unified revenue administration is being established through the integration of the Income and Sales Tax Departments, legislation for which was approved by the lower house of parliament in May 2004."[34]

Nevertheless, two income tax administration issues were raised with us:

- The inability to obtain written tax rulings that bind the Jordanian Income Tax Department;

- The uncertainty created by the inevitable negotiations over the amount of tax paid on cross-border investment, given the unsatisfactory nature of many income tax rules, for example, Article 3 (B).

4.3 Issues Created by US Income Tax

Tax professionals and investors raised two main tax issues for Jordan-US investment that were created by US domestic income tax policy and law: the US branch profits tax and high US withholding tax rates on most income flows from the United States to Jordan.

[34] Ibid., p. 34.

In each case, US domestic rules tax income earned in the United States at high levels. The United States is prepared to levy taxes on this US source income at more reasonable levels but it will agree to do so only in a double tax treaty. In other words, high withholding tax rates have deliberately been put into US domestic tax law to encourage investment and trade partners of the United States to negotiate a double tax treaty with the United States. The high withholding rates are double tax treaty bargaining chips. The United States is prepared to reduce these rates with another country in return for that country agreeing to do the same. Likewise, the United States is prepared to assist another country enforce its tax law in return for that country agreeing to be the same for the United States.

A third US international income tax policy and law matter - the United States refusal to give a foreign tax credit for taxes foregone through Jordan's tax incentive program - was not raised with us. The reason for this may be that advisers and investors accept that the United States will not change its longstanding policy on tax sparing. Indeed, it needs to be noted that the OECD as a whole has been reconsidering its position on the subject of tax sparing. The recommendations of a 1998 OECD study are appended to this report in annex 8. The study identified three main concerns about the usefulness of OECD member countries granting tax sparing relief to developing countries. The first concern was the potential for abuse of tax sparing. The second was the effectiveness of tax sparing as an instrument of foreign aid. Finally, the OECD study had general concerns about the way tax sparing might encourage countries to use their tax incentive program.

4.3.1 US Branch Profits Tax and Branch-Level Interest Tax

A Jordanian company that operates its business or trade in the United States without incorporating it in that country is said to operate as a 'branch' in the United States. Although a 'branch' is a "legally dependent segment of an enterprise", it has its own organization and separate accounts and records (Vogel p. 214). The Arab Bank offices at 520 Madison Avenue in New York, for instance, operate as a 'branch' of Arab Bank plc, which is registered in Jordan as a public shareholding company. The Arab Bank plc has not legally incorporated its operations in New York.

Since 1986, the United States has levied branch profits tax and a branch-level interest tax on foreign companies engaged in business in that country. These taxes are levied in addition to the tax that branches pay on their income that is effectively connected with their business or trade in the United States. The two taxes are quite complex and a full description of them can be found in Bittker (pp. 67-195 to 67-123).

In essence, the branch profits tax in section 884(a) of the IRC is a withholding tax on withdrawals from a US branch of a foreign company. The income of a foreign company's US subsidiary is potentially taxed twice, once at the company level and once at the shareholder level. The branch profits tax substitutes for the dividend withholding tax that the United States would impose on dividends, if the branch were incorporated as a US subsidiary of the foreign company. In other words, the branch profits tax is designed to put US branches and subsidiaries of foreign companies on approximately the same footing in relation to US income taxes.

The issue for Jordanian companies that operate a branch in the United States is that the US branch profits tax makes it expensive for them to repatriate profits to Jordan for

reinvestment in Jordan or elsewhere. The US branch profits tax is an annual tax of 30 percent of the "dividend equivalent amount" on top of the regular US income tax. The 'dividend equivalent amount' is current branch earnings, minus the portions of those earnings that are reinvested in branch operations.

This rule creates an incentive for Jordanian companies operating as a branch in the United States to leave branch profits in the United States to grow year by year. Should the Jordanian company decide that it would be more profitable or prudent to reallocate some of its investment in its US branch to somewhere else in the world, it will face a large US tax cost. Jordanian companies argued that they could not defer repatriating these profits forever. A Jordanian company that left its branch profits in the United States to grow year by year would inevitably face liquidity problems at some time (a difficulty in funding its capital needs in other parts of its operations or in paying dividends to shareholders) and the building up of an excessive tax provision in its financial accounts.

The branch-level interest tax in section 884(f) of the IRC seeks to treat interest paid by a US branch and a separately incorporated US subsidiary in the same way. First, if a US branch of a Jordanian company pays interest to a foreign person, US withholding tax may apply. Secondly, if the interest deduction allowed to a Jordanian company exceeds the interest paid by the Jordanian company's US branch, the 'excess interest' is treated as if it were paid by the US branch to the Jordanian company. The excess interest is then taxed at 30 percent, unless it is exempted or taxed at a reduced rate under a double tax treaty. Branch-level interest tax at a high rate of 30 percent encourages investors to keep their investment in the United States.

To conclude, in the absence of a double tax treaty, the US branch profits taxes can create issues for Jordanian investment in the United States. Jordanian investors in the United States can face paying 30 percent US branch profits taxes on top of US federal income tax, state income tax, and city income tax, should they choose to repatriate their income to Jordan.

4.3.2 High US Withholding Tax Rates

US domestic income tax law imposes a high withholding tax of 30 percent on gross receipts from investment income and some capital gains earned from the United States by Jordanian persons who are not engaged in a US trade or business.

Investment income includes dividends, interest, rents, royalties and other fixed or determinable annual or periodical income from sources within the United States, among other things. The US domestic rules concerning withholding tax at source are very complex. Regulations set out in great detail how the obligation is to be implemented (for detail, see Bittker pp. 67-122).

US domestic income tax law does allow certain exemptions and reduced rates to apply to specific items of income, whether the recipient of the income is a resident of a country with which the United States has a double tax treaty or not.

Unfortunately, the US withholding tax exemptions and reduced rates in US domestic law are limited. Take interest paid by a US person to a Jordanian person, for example. The general rule is that the gross amount of interest paid is subject to US withholding tax of

30 percent. There are statutory exemptions from withholding for interest on deposit with certain financial institutions and interest on certain instruments issued for 183 days or less.

If, for reasons of return and prudence, a Jordanian bank sought to invest in a diverse portfolio of US debt instruments, it would find that some of them were subject to 30 percent US withholding tax, while others were not. It would not be possible for that Jordanian bank to hold a diverse portfolio of US debt instruments without paying 30 percent US withholding tax on some of its debt investment portfolio.

To conclude, in the absence of a double tax treaty, US domestic withholding tax rules can create issues for Jordanian investment in the United States. Unless there is an applicable US domestic law tax exemption or reduced rate, Jordanian investors in the United States can face paying 30 percent US withholding tax on top of US federal income tax, state income tax, and city income tax, should they choose to repatriate their income to Jordan.

4.4 When Do Tax 'Issues' Become 'Barriers' to Investment?

For Jordanian tax policymakers, the hard issue is to decide whether any one of these tax 'issues', or combinations of particular tax 'issues', are creating a 'barrier' to quality direct investment in Jordan that will create jobs, and lead to a transfer of technology, skills and ideas to Jordan.Two things are certain: multinational companies and other cross-border investors in Jordan do not:

- pay statutory rates of income tax on their economic income; or,
- fund investment in Jordan solely from 'retained earnings' in foreign branches or subsidiaries.

First, multinational companies and other cross-border investors have many ways of minimizing the tax they pay through tax-effective financing methods like cross-border leases, transfer pricing and thin capitalisation of subsidiaries, for example. Second, multinational companies can fund investment through raising 'new equity capital' or 'debt' in addition to using 'retained earnings'. Indeed, much MNE investment is funded by debt finance and it is the cross-border tax treatment of debt rather than new equity or retained earnings that is the main issue.

Consequently, it is not sufficient for investors to argue on the basis of statutory US federal, state and city income tax rates plus statutory US withholding tax rates that Jordanian investment in the US currently faces a 50 to 60 percent cumulative tax rate and that this is a 'barrier' to repatriating profit to invest in Jordan. First, the 'barrier' is not the 50-60 percent aggregation of US statutory rates. To get closer to a realistic figure, it is necessary to calculate a weighted average tax rate on the Jordanian company's capital exported to the United States and invested there, making some assumption about the mix of equity, retained earnings and debt invested in the US business and then calculating the tax on the proportions of Jordanian equity, Jordanian and foreign debt and retained earnings. We are not even in a position to estimate that typical weighted average tax rate for Jordanian companies investing in the United States but are confident that it is much lower than 50-60 percent. If it were not, Jordanian companies would not be investing in the United States.

A second issue for Jordanian policymakers to consider is that even if a Jordan-US DTA were negotiated and it lowered US withholding and branch taxes, it does not follow that Jordanian investors in the United States would be more likely to repatriate US earnings to Jordan in order to invest them in Jordan.

US economic research suggests reducing withholding taxes does not increase foreign direct investment. Starting in 1985,[35] this line of literature is now supported by empirical work that shows withholding taxes do not significantly affect levels of investment for US firms.[36] Still other empirical research found permanent changes in withholding taxes did not affect the pattern of profit repatriation by US firms.[37] We are not aware of any similar empirical research that has been done for Jordanian firms. Equally, we are not aware of any reasons why the theoretical underpinnings of this research should not apply to Jordanian multinational companies in the same way that it has been shown empirically to apply to US firms.

4.5 Conclusions

Jordan's income tax law and administration is the major cause of tax issues for cross-border investment between the Unites States and Jordan. While some Jordanian investors in the United States raised issues concerning US branch profits and withholding tax rates, a long line of US economic literature starting in 1985 suggests that reducing withholding tax does not increase foreign direct investment by US firms. Consistent with these research findings, many countries in the world continue to impose taxes and withholding obligations on dividend repatriations and dividend distributions to shareholders. Jordan, on the other hand, has recently stopped deducting non-resident withholding tax on dividends.

[35] Hartman, D, "Tax Policy and Foreign Direct Investment," (1985) 26 *Journal of Public Economics* 107-121.

[36] Grubert, H., "Taxes and the Division of Foreign Operating Income Among Royalties, Interest, Dividends, and Retained Earnings", (1998) 68 *Journal of Public Economics* 269-290.

[37] Altshuler, R., T. S. Newlon and W. Randolph, "Do Repatriation Taxes Matter? Evidence from the "Tax Returns of US Multinationals", in M. Feldstein, J. Hines, Jr. and R.G. Hubbard. eds., *Effects of Taxation on Multinational Corporations*, (Chicago: University of Chicago Press, 1995), pp. 253-272.

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5. Three Options for Resolving Jordan-US Tax Issues

5.1 Introduction

International tax issues may be resolved in several ways:

- unilaterally through unconditional provisions in domestic law;
- unilaterally through conditional provisions in domestic law; or,
- bilaterally through treaties, especially DTAs.

5.2 Option 1: Unconditional Unilateral Provisions in Domestic Law

As discussed in section 4.2, most of the tax issues for Jordan-US cross-border investment seem to be caused by Jordan's income tax law and administration. The most effective way of resolving these issues is to consider amending Jordan's income tax law and making changes to Jordan's income tax administration.

One way of reducing the lobbying for Jordan to negotiate many double tax treaties would be for Jordan to include unilateral double tax relief measures in its domestic law. Many countries do this on an unconditional basis. The United States, for example, offers a unilateral foreign tax credit in its domestic law. Many other countries, like New Zealand, do the same. This is one issue that should be considered in the comprehensive review of Jordan's income tax.

5.3 Option 2: Conditional Unilateral Provisions in Domestic Law

For some cross-border issues, another option is to resolve cross-border tax issues by amending national tax law on a conditional basis. In other words, Jordan would state in its domestic law that it exempted certain income from Jordanian income tax on a reciprocal basis.

The Jordanian Income Tax Law already has some provisions like this. Article 7 (B)(3) and (4), for instance, state that the following shall be exempted from Jordanian income tax:

> *3) The emoluments and salaries paid to diplomatic envoys and members of the non-Jordanian consular corps in their capacities as representatives of their countries in the Kingdom, and subject to reciprocal treatment.*
>
> *4) Salaries and wages paid to non-Jordanian employees working with Jordanian Diplomatic or consular offices outside the Kingdom subject to reciprocal treatment.*

In its domestic income tax law, New Zealand offers conditional unilateral relief from New Zealand income tax, for example, to foreign aircraft operators if the Commissioner of Inland Revenue is satisfied that that in corresponding circumstances a New Zealand aircraft operator would be exempt from tax in that country.

5.4 Option 3: Bilateral Agreements

The third option is to attempt resolution of international tax issues through negotiating international agreements, like Double Tax Agreements, with other countries. There is **little opportunity in the DTA to craft a specific solution to a specific problem** in a bilateral investment relationship, however. DTAs follow a relatively rigid formula and many countries are reluctant to negotiate special provisions in one treaty, without thinking very carefully about the consequences for their existing treaties and any future treaties.

One of the major benefits that DTAs provide to cross-border investors is some certainty about the tax treatment of their investment in a foreign country over a relatively long period. Tax treaties often last some 20 to 30 years with little or no amendment. Domestic tax legislation, on the other hand, is much more likely to be amended within this timeframe in a way that may detrimentally affect the return a foreigner expects on their investment. Where domestic tax law amendments are contrary to a provision in a DTA, in most countries the earlier DTA provision will prevail. Other international treaties, like bilateral investment agreements, can deal with the tax treatment of foreign investment but generally this is done in a more limited way.

In many cases, double tax treaties do not reduce the amount of tax paid by a cross-border investor but rather change how much tax the investor pays to each government. As DTAs divide the total income tax revenue from two-way investment flows each year between two parties for around 20 to 30 years, Jordan should analyze the costs and benefits of these agreements carefully taking a 20 to 30 year perspective.

One of the major benefits that DTAs provide to a government is the ability to obtain tax information from the foreign country on their residents' investments offshore. This is particularly important for a country that taxes its residents on their worldwide income. To the extent that the narrow interpretation of Article 3 (B) of the Jordanian ITL is correct and Jordan taxes relatively little offshore income (see the discussion of this in section 4.2), Jordan does not enjoy this major benefit from negotiating a DTA. Indeed, **we were told that Jordan does not ask for taxpayer information from its DTA partners using the exchange of information provisions in its DTAs.**

Negotiating a DTA does not immediately open the gates for foreign investment from that country, as Jordan itself has found with the 17 double tax treaties that has negotiated in the last 20 years. Recent economic research in the US suggests that other countries share this experience. Using both US and OECD FDI investment data, empirical research suggests that negotiating new DTAs is not very likely to increase FDI between the DTA partners and may actually decrease it for a period.[38] Further, more recent empirical research indicates that renegotiation of a double tax treaty also does not have a robust positive impact on FDI.[39]

[38] Blonigen, B.A. and R.B. Davies, "Do Bilateral Tax Treaties Promote Foreign Direct Investment?" (March 2002) NBER Working Paper 8834, available at <http://www.nber.org/papers/w8834>. Chapter draft prepared for forthcoming Blackwell book, *Trade, Laws and Institutions*, edited by James Hartigan; Blonigen, BA and RB Davies, "The Effects of Bilateral Tax Treaties on U.S. FDI Activity" (January 1, 2001). University of Oregon Economics Working Paper No. 2001-14. <http://ssrn.com/abstract=445980>.
[39] Davies, RB, "Tax Treaties, Renegotiations, and Foreign Direct Investment" (June 2003). University of Oregon Economics Working Paper No. 2003-14. <http://ssrn.com/abstract=436502>.

6. DTAs Can Harm Jordan's Economic Objectives

6.1 Introduction

> Tax treaty provisions like their counterparts in domestic tax legislation are undergoing a fundamental change in perspective. Historically, treaties were entered into an order to avoid double taxation. A second objective was the prevention of evasion by means of exchange of information between tax authorities. In recent times, however, particularly as treaty networks have grown, attention in relation to tax avoidance has spread from the domestic to the treaty area. Several major UK departures from the OECD Model in terms of its negotiating position are addressed almost entirely to avoidance issues.[40]
>
> *International tax expert on UK tax treaty law and practice (2002).*

Jordan's revenue and income tax objectives may be harmed by a DTA that gives more priority to the interests of Jordan's treaty partner than to Jordan's interests, a DTA that does not work well with current tax law in both countries from the outset, or a DTA that fails to keep up with changes in economic and tax policy in one or other of the two double tax treaty countries.

When a double tax treaty is first negotiated, Jordan's negotiators should adopt a 20 or 30 year time horizon, as Jordon Vision 2020 did, in choosing the investment, revenue, income tax and other economic objectives that Jordan seeks to advance in the negotiations. DTAs tend to stay in place for very long periods – often they last 20 or 30 years, without amendment.

Even if Jordan's negotiators do adopt such a long time horizon in setting goals and are successful in negotiating a double tax treaty that provides net benefits to Jordan and works well with the tax law in the two countries, **it is imperative to set aside resources for renegotiating treaties**. **DTAs can become outmoded** as a result of general political and economic change, financial and technological innovation, and changes in Jordan's tax policy and law. The importance of keeping DTAs in a good state of repair is reflected in the experience of a large country like the United States and a small country like New Zealand.

In explaining how the United Staes sets its tax treaty program priorities, a former international tax counsel at the **US Treasury** explained that the Treasury's **top priority was not negotiating new treaties but making sure that outdated treaties were renegotiated**:

> *Priorities have to be established consistent with Congressional and Treasury policies, and the views of other governmental departments and the international business community. The Treasury's first priority for treaty negotiations is to renegotiate outdated treaties that lack effective anti-abuse clauses and that do not reflect recent changes in US tax legislation. … We have made it clear to our treaty partners that we will not tolerate continuation of treaty relationships that fail to reflect important US treaty policies. This policy is underscored by the termination*

[40]Schwarz, J, *Tax Treaties: United Kingdom Law and Practice* (London, Sweet & Maxwell, 2002), p. 177.

> *of our treaties with Malta and Aruba, and by the termination protocol with respect to the Netherlands Antilles.*
>
> *A second priority is to conclude treaties that the likely to provide the greatest economic benefits to both US and foreign-based businesses and individuals. … As we complete our renegotiations of outdated treaties, we are able to increase the priority we place on negotiating tax treaties in countries and regions of increasing importance to the United States and US business.*
>
> *…A third priority is to conclude treaties with countries with which we lack of treaty, but that have the potential to be significant trading partners.*[41]

The risks that outdated treaties pose for small countries like Jordan are just as great. Unfortunately, their resources for monitoring and maintaining DTAs are much more limited than those available to the United States. As a consequence, **small countries need to be very cautious in agreeing to negotiate DTAs.** They need to target their scarce bureaucratic resources at negotiating a few good DTAs with their major investment and trade partners. New Zealand, with a population of just four million people, is one such country. In its briefing papers for an incoming government in November 1999, the New Zealand Inland Revenue Department explained that although it was negotiating two new treaties at the time:

> *A large part of our treaty team's DTA work involves negotiating remedial amendments to our existing treaties, at either our request, or the request of our treaty partners. For example, we have recently negotiated protocols to revise existing DTAs with China, India and Korea. These protocols removed the ability of investors to exploit tax sparing provisions in those treaties in an unintended manner. The protocol with India also reduced the withholding rates faced by New Zealand investors into India, which has positive benefits for our business community. A number of other protocols are awaiting finalisation or are being negotiated.*
>
> *As well as maintaining our agreements, the treaty team also provides a range of treaty services including notifying our treaty partners of changes in tax law in New Zealand, documenting our existing DTAs, and enhancing our DTA interpretation services.*[42]

One problem for small countries, like Jordan and New Zealand, as opposed to large countries like the United States, is that **it may be difficult to get the agreement of another country to renegotiate a double tax treaty to keep it up-to-date**.

Even if the other country does agree to renegotiate, it will generally want something in return for agreeing to renegotiate a treaty. Appendix 9.1 to this report is a National Interest Analysis prepared by the New Zealand Inland Revenue Department about a recent Protocol amending the New Zealand-Netherlands DTA. The main reason that New Zealand sought this amendment of the treaty was to stop New Zealand source income being distributed out of New Zealand without being subject to New Zealand tax. Dutch residents were able to characterize profits earned in New Zealand as 'insurance

[41] Guttentag, J., *Emerging Issues in Taxing Business in a Global Economy*, SG/APEC/CFA(96)4, (1996) pp. 3-4.

[42] New Zealand Inland Revenue Department, *Supplementary Briefing Papers, Vol 1 Tax Policy*, November 1999, pp33. Available at <http://www.taxpolicy.ird.govt.nz/publications/files/volume1.doc>.

premiums', which the New Zealand-Netherlands DTA allowed to be distributed out of New Zealand without any New Zealand tax. When New Zealand approached the Netherlands to close this tax avoidance opportunity, the Netherlands suggested that a number of other issues should be discussed at the same time. Paragraph 11 of the National Interest Analysis on page 72 of this report notes that one of the other matters eventually included in the Protocol (limiting source taxation on 'other income' not covered by any of the specific articles in the treaty) may have a small revenue cost associated for New Zealand.

6.2 Harming Jordan's Income Revenue Objectives

Jordan's DTAs have relatively little revenue upside for Jordan. Jordan's main income tax revenue objective is to tax one tax base: economic activity that takes place in Jordan. Jordan should need little assistance from any other country to tax this activity. As we saw in section 4.2, the better view seems to be that Jordanian taxation of offshore income through Article 3 (B) of Jordan's ITL is relatively narrow in scope for most taxpayers.

Jordan's DTAs have relatively large revenue downside for Jordan. Jordan largely taxes only income earned in Jordan and all of Jordan's DTAs reduce its right to tax that income. There is no offset for Jordan, as there is for countries that tax their residents on their foreign income, like the United States. Each of Jordan's DTAs gives Jordan greater taxing rights in relation to the foreign income of its residents. Jordan largely chooses not to exercise those rights in its domestic tax law (the problematic Article 3 (B) of Jordan's ITL is the one exception). Further, DTAs may require Jordan to surrender the right to tax economic activity in Jordan where Jordan's income tax would not have deterred the foreigner from investing in Jordan, either because Jordan's income tax is creditable in the home country or the foreign investor is earning economic rents (see section 7.6).

Appendix 12 reproduces four documents to show how DTAs are used by cross-border investors to reduce and avoid taxation on their investment. Appendix 12.1 is a copy of a recent report by major worldwide accounting firm PricewaterhouseCoopers showing how recent DTAs negotiated in the Asia Pacific and in Europe can be used to ensure that little or no income tax is paid in host countries on foreign investment.

The PricewaterhouseCoopers report in Appendix 12.1 contains an estimate that **60 percent of foreign investment into India over the last 10 years has been undertaken through Mauritius 'shell' companies** set up by residents of neither India nor Mauritius to take advantage of favorable provisions in the India-Mauritius DTA. It also records the unsuccessful attempts by the Indian revenue authorities to challenge in Indian courts the validity of these 'shell' companies set up by residents of neither India nor Mauritius.

Clearly, the Indonesian Government is concerned about the use that investors are making of the Indonesia-Mauritius DTA. The PricewaterhouseCoopers report in Appendix 12.1 also notes that the **Indonesian government has sent a notice to the Mauritius government requesting a broad renegotiation of their DTA** and that one possibility is that the treaty may have to be terminated although the Indonesian authorities do not expect that.

Another part of the PricewaterhouseCoopers report in Appendix 12.1 notes an increasing trend for countries that have DTAs with Malaysia to exclude from their Malaysian DTA

the tax haven territory in Malaysia of Labuan. It seems many multinational companies have established holding companies for their worldwide or Asia-Pacific investments in Labuan with the intention of relying on treaty concessions in the appropriate Malaysia DTA. Since 1996 the UK, the Netherlands, Japan and Australia have negotiated amendments to their DTAs with Malaysia to exclude Labuan from the scope of those DTAs. An exchange of letters between Australia and Malaysia in 2002, for instance, provides that the benefits of the Australia-Malaysia DTA 1980 shall not be available to persons carrying on any offshore business activity under the Labuan Offshore Business Activity Tax Act 1990 as amended. Recent Swedish and Luxembourg DTAs also exclude Labuan. Korea is negotiating with Malaysia to do the same.

The case of investors using tax structures in Labuan, Malaysia for their investment into Korea is of interest to Jordan, should Jordan broaden its tax income base so that more Jordanians investing in Jordan will pay Jordanian income tax on this investment. Labuan

> has become a major conduit for FDI into the surrounding economies, especially Korea. It is thought that somewhere between one-third and one-half of the 2,500 companies registered on the island are somehow linked to Korea. Many Korean companies themselves have invested back into Korea through Labuan.[43]

It is that last sentence in this quotation that is arresting: **Korean companies are investing back into Korea through Labuan**.

Another major worldwide accounting firm, Ernst & Young, have had discussions with the Korean Tax Authorities (KTA) on this topic (see appendix 12.4) and confirm

> We understand that, the KTA, now, believe that the treaty may be being abused by Korean tax residents investing in Korea via Labuan entities.[44]

In other words, many Korean residents investing in Korea will be paying Korean income and capital gains tax on their Korean investments. Other Korean residents investing in Korea are not paying Korean income and capital gains tax on their Korean investments by setting up an entity in Labuan, Malaysia, and making their domestic investment in Korea through that entity. **Jordan also has a DTA with Malaysia and as that DTA includes Labuan, Jordan's domestic income tax base is potentially at the same risk as the Korean income tax base. The risk will be greater if Jordan broadens its income tax base. The Jordanian Income Tax Department should investigate.**

Jordan has also been negotiating DTAs with a number of other countries that seek to provide a treaty conduit between foreign investors from third countries and a host investment country, like Jordan. Jordan should examine very carefully the text of the DTA that it has signed but not yet implemented with Malta and its interaction with Malta's tax law and be cautious in relation to the DTA negotiation proposal it has received from Cyprus and its interaction with Cyprus tax law,[45] notwithstanding

[43] See <http://www.lowtax.net/lowtax/html/jlbcfir.html>.

[44] [44] See <http://www.ey.com/GLOBAL/content.nsf/China_E/Issues_&_Perspectives_-_Article_-_Korean_Investment>.

[45] Rigby, M, "A Critique of Double Tax Treaties as a Jurisdictional Coordination Mechanism" (1991) 8 *Australian Tax Forum* 303-423 at 422. Rigby describes Cyprus as "a recent example of a country that has set itself up as a treaty conduit in a way that abuses source country interests." He briefly describes the three features of Cyprus tax law that enable Cyprus to achieve that objective.

their commitments to the OECD in relation to harmful tax competition. The royalty provisions in the Jordan-Netherlands DTA[46] and in the Switzerland DTA proposal, in particular, are also matters to review.

Appendix 12.2 contains descriptions by the New Zealand and Australian Governments of tax avoidance schemes that involved their DTAs and that were designed effectively to offset tax sparing credits against tax liabilities not relating to the foreign investment which gave rise to the tax sparing credit. Two of the schemes discovered by the New Zealand Inland Revenue Department involved loans of hundreds of millions of US dollars. The note adds that the New Zealand Inland Revenue Department discovered, during an audit of an international financial institution, correspondence confirming that the scheme was being used in Asia.

Appendix 12.3 relates to a tax loophole in a New Zealand DTA that allowed non-residents to pay no source income tax in New Zealand by characterizing their income as 'cross-border insurance premiums'. New Zealand has recently negotiated a Protocol to the New Zealand-Netherlands DTA to close the loophole.

6.3 Harming Jordan's Income Tax Policy Objectives

Jordan is likely to make the task of reforming its international income tax rules more difficult as DTAs are not based on good tax policy principles. DTAs create distortions. There are a number of examples of how DTAs bias investors' choice. We shall briefly outline one of them. DTAs artificially divide income into different categories (business profits, dividends, interest, royalties, for instance) and then tax the different income categories at different tax rates. This creates a large incentive for taxpayers, like multinational company groups, to characterise their income according to the tax treatment. If royalties are a deductible expense in a country of investment and a DTA provides that payments of those royalties shall suffer no non-resident withholding tax, multinational companies have an incentive to repatriate profits out of the country of investment as non-taxable royalties rather than as 'business profits' that are taxable in the country of investment. The end result is that the country in which the economic activity takes place may levy little or no tax on income generated within its territory by a foreign investor.

In addition, there is often a long period between amendment of DTAs - often up to 20 years. If in that period, a country wishes to reform its income tax to make it more efficient and equitable, it must check all of its DTAs, to make sure that any reform proposals do not breach its DTA obligations, often given in slightly different terms to achieve agreement with a particular country. A country may have 60 DTAs and 55 of them may allow a particular reform. If the reform breaches the DTA obligations in the other five treaties, the country has the unenviable choice of either seeking to renegotiate each of those five treaties, designing special, and often complicated, regimes that circumvent the DTA obligations in the five treaties, legislating the changes and unilaterally overriding the DTA provisions in the five treaties or abandoning the reform proposals. If the country enacts the reforms and takes no action in relation to the five

[46] Rigby, M, "A Critique of Double Tax Treaties as a Jurisdictional Coordination Mechanism" (1991) 8 *Australian Tax Forum* 303-427 at 423. Rigby describes how the Netherlands has set itself up as a treaty shopping conduit for one type of income, namely royalty payments.

DTAs, investors are likely to restructure their investments, so that they can receive the benefit of treaty protection under one of those five treaties.

There are many examples of income tax reform designed to make a tax system more efficient and equitable where DTA obligations have made the task of the domestic tax policymaker more difficult.[47] Here are some examples:

- Domestic law proposals to tax resident shareholders of controlled foreign companies on their pro rata share of income earned by the companies, as it is earned each year, rather than just on distribution (is this consistent with the 'business profits' or the 'tax sparing' articles in DTAs?)

- Domestic law proposals to deny interest deductions were interest is payable in respect of foreign debt, and the debt to equity ratio of the investment exceeds a specified level (is this consistent with the 'associated enterprises', 'business profits'and 'nondiscrimination' articles in DTAs?)

- Domestic law proposals to impute company income tax to domestic shareholders only, and not to nonresident shareholders (is this consistent with 'nondiscrimination' articles in DTAs?)

Negotiating a large number of DTAs, monitoring them, maintaining them and administering them will also divert scarce resources from more pressing tax matters. With each DTA, Jordan takes on additional responsibility to help one more country administer its tax system and gets little or no help in return, as Jordan's income tax is largely territorial and Jordan does not need other countries' help to enforce taxation of economic activity that occurs in Jordan.

6.4 Conclusions

With every DTA that Jordan negotiates:

- **Jordan gives away income tax revenue.** Jordan largely taxes only income earned in Jordan and all of Jordan's DTAs reduce its right to tax that income. There is no offset for Jordan, as there is for countries that tax their residents on their foreign income, like the United States. Each of Jordan's DTAs gives Jordan greater taxing rights in relation to the foreign income of its residents. Jordan largely chooses not to exercise those rights in its domestic tax law;

- **Jordan takes on additional responsibility to help one more country administer its tax system and gets little or no help in return**, as Jordan's income tax is largely territorial and Jordan does not need other countries' help to enforce taxation of economic activity that occurs in Jordan;

- **Jordan is likely to make the task of reforming its international income tax rules more difficult**, as DTAs are not based on good tax policy principles, and with each DTA Jordan will have made slightly different concessions to achieve

[47] Ibid., pp. 3111-385.

agreement, with the result that some reform options may now be more difficult to implement;

- **Jordan diverts scarce resources from more pressing tax matters to negotiating, monitoring, maintaining and administering DTAs.**

Many countries now place as much, if not more, emphasis on renegotiating out-of-date DTAs. In this section, we gave examples of the priority given by the United States, New Zealand, the United Kingdom, the Netherlands, Japan, Australia, Korea, and Indonesia to renegotiating treaties that contained provisions that were being abused.

7. Appropriate Jordanian Regime for Taxing International Business Income

7.1 Introduction

Jordan has been opening its economy to international capital to achieve higher growth and a better standard of living for all Jordanians. According to *Jordan Vision 2020*, Jordan requires 47 billion JD in new domestic and foreign investments to double Jordan's per capita GDP in real terms over the next 20 years. This is an important point. There are two sources of investment for Jordan: Jordanians and foreigners. As we seek to show through stylized economic models in this section, the way a small open economy, like Jordan, taxes cross-border transactions undertaken by Jordanians and foreigners may have a significant effect on the pattern and quality of investment in Jordan, as well as the price that firms in Jordan pay for international capital. In other words, Jordan's international tax rules may have a significant effect on how much economic growth and employment an open Jordanian economy actually creates.

In addition to investment, Jordan also needs revenue and a credible fiscal plan to achieve its long-term growth goals. In particular, Jordan needs to convince markets that it has a sustainable long-term plan to reduce its high debt burden and its dependence on external grants. To date, Jordan has undertaken the easy part of income tax reform - lowering company and personal tax rates. To raise the current revenue to GDP ratio from three percent will require Jordan undertaking the much more difficult part of income tax reform - broadening the income tax base. To ensure that this reform constrains economic growth as little as possible, Jordan should minimize the compliance costs imposed on taxpayers and the administrative costs imposed on government. Jordan should also ensure the reform minimizes changes in taxpayer behavior - whether it is a change in where they invest (Jordan or overseas) or whether they consume or save, for example. Ideally, Jordan's next income tax reforms should both increase revenue and reduce the economic costs that arise from taxpayers making decisions that they would not have made in the absence of Jordan's income tax.

For a small open economy that is both heavily reliant on foreign investment and that needs to raise more income tax revenue, the risks for poor policy design and administration of Jordan's income tax system are great:

- foreign investment, with skills and technology it brings, may be discouraged;
- the domestic cost of capital for firms in Jordan may be increased;
- foreign and domestic investment may make an inefficient use of Jordan's resources;
- income tax revenue may be transferred to another country for no gain in investment in Jordan;
- income tax revenue may fall as a result of increased avoidance and evasion;

- Jordan may become an unattractive place from which to do business in the region; and,

- Jordanians may increasingly question the fairness of their tax system.

As a consequence of these risks and opportunities, Jordan needs to take considerable care in formulating its international tax policy. It needs an economic framework within which it can begin developing and implementing policy incrementally and monitoring the effects of each reform as it is made. It will need to consult widely and to sell its reforms to business. It must take into account the many different types of income tax systems offshore: high tax countries; medium tax countries; low tax countries; and, tax havens. Further, international tax rules must interface with rules or silence in the tax systems of over 190 other countries. Finally, international tax policy must cope with the regular amendment of both national and foreign tax law. In many countries, tax legislation is larger and more amended than any other area of law.

Reviewing and implementing change in Jordan's income tax system will thus be a large and on-going task. As two IMF economists recently concluded from developing country experience of tax reform in the 1990s, "ten years is a relatively short period in the life of a tax system."[48] The implication is not that Jordan can afford to wait, especially since Jordan's central government fiscal outturn registered a large surplus in the first quarter of 2004. The implication is that Jordan should proceed immediately and start what will be a long and difficult process. The erosion of corporate tax revenues in developing countries generally, seemingly as a result of increased international tax competition, is one of the main developments of the 1990s that the two IMF economists identify in that recent research.

Yet, if Jordan does not get its income tax reforms right, it will greatly reduce the benefits it achieves from opening its economy to international capital flows in the first place. Jordan's income tax rules are one of the key mechanisms open to the Jordanian Government to design rules that ensure both foreign and Jordanian private investors face trade-offs that echo the relative costs and benefits from Jordan's national perspective.

In line with the limited scope of work for this consultancy on this topic, it is possible only to sketch some stylized examples to make a fundamental point about the linkages between taxing residents and non-residents and why Jordan needs to do a better job of coordinating the two arms of international income tax. Section 7.2 sets out four broad international tax options for countries. Section 7.3 illustrates why the current Jordanian international tax model is inefficient and not good policy. Section 7.4 illustrates why implementing the AMIR tax incentives report recommendations needs to be done in conjunction with wider reform, as that report itself recommended. Section 7.5 considers the international tax model that is widely accepted by economists to be theoretically advisable for a small open economy that both imports and exports capital. Finally, section 7.6 suggests an appropriate international tax model for a small open economy that seeks an efficient income tax system, taking into account practical considerations and other constraints.

[48] Keen, M and A Simone, *Tax Policy in Developing Countries: Some Lessons from the 1990s, and Some Challenges Ahead*, manuscript, p 2. To appear in S Gupta, B Clements, and G Inchauste (eds): Helping Countries Develop: The Role of the Fiscal Policy.

The review below starts with theoretical analysis that does not seek to describe the real world in Jordan in 2004 or in any other country at any time. It does not take into account important factors influencing investment like the political and economic stability of a country or the infrastructure available in the country, for example. Instead, it constructs a simplified and stylised model of small open economies in general to act as a guide to making tax policy generally in this type of economy. In other words, the purpose of this brief theoretical analysis is to identify some broad objectives that might guide policy for taxing income from business investment in a small open economy. Following this brief theoretical analysis, the report draws out some of the implications for current income tax reform proposals in Jordan. Much more research will be necessary to devise detailed reform proposals that are appropriate for Jordan.

In the theoretical analysis in sections 7.2 to 7.5 below we make six assumptions:

(1) World capital markets set a rate of return of 10 percent that foreign investors are able to earn after all taxes by lending money anywhere in the world, which means Jordanian businesses would have to pay 10 percent after Jordanian income tax to attract foreign investment;

(2) Jordan is a small open economy that forms a small part of the world capital market. The investment behavior of Jordanian residents thus has no effect on the world rate of return. Foreign capital, on the other hand, is highly sensitive to the rates of return available in Jordan;

(3) The Jordanian Government implements its announced intention to broaden its income tax base by eliminating widespread exemptions;[49]

(4) To simplify the analysis, it is assumed that a person who is saving in Jordan can earn a 10 percent rate of return on investment before Jordanian income tax. The Jordanian income tax rate on business income is 20 percent, which means that the person saving in Jordan earns an after-tax rate of return of 8 percent on their investment;

(5) To further simplify the analysis, we assume no taxes are paid offshore;

(6) We temporarily leave aside, for analysis in section 7.6, two possible situations where taxing non-resident multinational enterprises in Jordan may not discourage investment in Jordan. The first is where the non-resident MNE earns 'supernormal' profits in Jordan, perhaps from monopoly profits or exploiting natural resources. The second is where the non-resident MNE in fact receives an income tax credit for Jordanian income tax in the country through which they invest in Jordan. We also temporarily leave aside for analysis in section 7.6 the broad effect of rules in Jordan's double tax treaties and tax administration considerations.

[49] See note 2 *Memorandum of Economic and Financial Policies, 2002-04*, paragraph 21 on p 9.

7.2 Four Broad International Tax Models

There are four broad international tax models with varying combinations of taxes.[50] The first and fourth models are at the two extremes of no taxation of international income and full taxation of all international income, respectively. The second and third models are intermediate positions between these two extremes. The four models are:

1. Jordan **neither** taxes Jordanian residents on their foreign income **nor** non-residents on their Jordanian income;

2. Jordan **taxes** Jordanian residents on their foreign income and **exempts** non-residents on their Jordanian income;

3. Jordan **exempts** Jordanian residents on their foreign income and **taxes** non-residents on their Jordanian income;

4. Jordan fully taxes **both** Jordanian residents on their foreign income **and** non-residents on their Jordanian income;

7.3 Problems Taxing Neither Non-Residents nor Residents on International Business Income

In international tax model 1:

- Non-residents who invest in Jordan pay no Jordanian income tax; and,

- Jordanian residents who invest offshore pay no Jordanian income tax on their foreign income.

Non-residents

As non-residents who invest in Jordan do not have to pay any Jordanian income tax, they require a 10 percent rate of return to make an investment in Jordan. This 10 percent pre-tax rate of return also gives them their required 10 percent post-tax rate of return.

As Jordan does not impose any tax on non-resident investors, who are likely to be the marginal providers of capital in Jordan, the cost of capital in Jordan will be the same as the world rate. Put another way, interest rates in Jordan will equal the world rate of 10 percent.

Jordanian residents

Assuming Jordan broadens its income tax base by eliminating widespread exemptions, Jordanians would now pay 20 percent income tax on all of their business investment in Jordan.

[50] This analysis draws on work done in reforming New Zealand's international tax rules. The consultant was part of a large multidisciplinary team that analysed the economic and legal issues for New Zealand, which, like Jordan, is a small open economy that both imports and exports capital.

As Jordan imposes 20 percent income tax whenever Jordanians invest in Jordan, the 10 percent pre-tax rate of return becomes 8 percent after-tax.

If Jordanians invest offshore, they will earn the world rate of return of 10 percent. They will pay no Jordanian income tax. Their after-tax return will therefore be 10 percent.

Implications

There would be two main implications for Jordan from this combination of income taxes in international model 1:

- The cost of capital in Jordan would equal the 10 percent world rate of return. Ultimately, most business investment in Jordan would be owned by non-residents, who still would require the world rate of return to invest in Jordan.

- As residents sold their investments in Jordan and moved their capital offshore, the income tax revenue collected in Jordan on business investment would ultimately decrease to little or nothing. The only investors paying Jordanian income tax on business investment in Jordan would be residents and they would have no incentive to invest in Jordan.

Clearly, this combination of international income taxes is bad policy for Jordan from an investment and an income tax revenue perspective. From Jordan's national investment perspective, it would result in an inefficient use of Jordanian resources. Jordanian residents would not seek the highest pre-tax rate of return anywhere in the world. They would be prepared to invest in projects offshore that have lower than 10 percent pre-tax rates of return. From an income tax perspective, Jordan's revenue from business investment ultimately would dwindle to little or nothing.

With the exception of Article 3 (B) taxation of offshore investment by Jordanian residents, which seems to be applied in a very uneven manner to a very limited group of Jordanians (see section 4.2), **this model is very close to the existing set of international income tax rules in the Jordanian ITL**. Most non-residents investing in Jordan enjoy a tax holiday. The application of Article 3 (B) to Jordanian businesses investing offshore is, we were told, very uneven (see section 4.2).

If the Jordanian Government implements its announced intention to broaden its income tax base by eliminating widespread exemptions without making changes to its international tax rules at the same time, Jordanians who currently own investments in Jordan would seriously reassess whether they should keep this investment or sell and invest their capital offshore. The many Jordanians, whom we were told have much of their capital offshore because of instability in the region, would have one more reason not to repatriate their capital.

7.4 Problems Taxing Source Income Only

In international tax model 3:

- Non-residents who invest in Jordan pay Jordanian income tax; and,

- Jordanian residents who invest offshore pay no Jordanian income tax on their foreign income.

In other words, Jordan now taxes all income with a Jordanian source, regardless of whether it is earned by residents or non-residents. This is pure source taxation.

Non-residents

As non-residents who invest in Jordan now have to pay 20 percent Jordanian income tax, they now require a 12.5 percent pre-tax rate of return to invest in Jordan so that they can earn their 10 percent post-tax rate of return.

As Jordan now imposes tax on non-resident investors, who are likely to be the marginal providers of capital in Jordan, the cost of capital in Jordan for all Jordanian firms will now rise to 12.5 percent.

Residents

Assuming Jordan broadens its income tax base by eliminating widespread exemptions, Jordanians would now pay 20 percent income tax on all of their business investment in Jordan.

As the cost of capital in Jordan has now risen to 12.5 percent, when Jordan imposes 20 percent income tax whenever Jordanians invest in Jordan, that 12.5 percent pre-tax rate of return becomes 10 percent after-tax.

If Jordanians invest offshore, they will earn the world rate of return of 10 percent. They will pay no Jordanian income tax. Their after-tax return will therefore be 10 percent.

As a result, the Jordanian income tax system no longer creates a tax incentive for residents to either invest onshore or offshore. The post-tax rate of return is the same 10 percent.

Implications

There would be three main implications for Jordan from this combination of income taxes in international model 3:

- The cost of capital in Jordan for all Jordanian firms will rise from the 10 percent world rate of return to 12.5 percent. This increase in the cost of capital for Jordanian firms would lead to less investment in Jordan and some combination of fewer jobs and lower incomes;

- The increased 12.5 percent rate of return on capital in Jordan might encourage more saving in Jordan;

- The tax incentive for Jordanian residents to invest offshore would have been removed;

- The Jordanian income tax base, which would now consist of tax raised on Jordanian and non-resident investment in Jordan, would be better secured.

This combination of international income taxes is better policy for Jordan from an investment and an income tax revenue perspective than international tax model 1. From Jordan's national perspective, it would result in a more efficient use of Jordanian resources. Jordanian residents would seek the highest pre-tax rate of return anywhere in the world. From an income tax perspective, Jordan's revenue from business investment would be better secured.

With the exception of Article 3 (B) taxation of offshore investment of Jordanian residents, which seems to be applied in a very uneven manner to a very limited group of Jordanians (see section 4.2) and existing foreign investment with a tax holiday, **this model is very close to what the international income tax rules in the Jordanian ITL would look like in relation to new foreign investment if Jordan implemented the AMIR tax incentive recommendations to stop giving tax holidays to new foreign investment.** The application of Article 3 (B) to Jordanian businesses investing offshore is, we were told, very uneven and applies to few Jordanian investors (see section 4.2).

If the Jordanian Government implements its announced intention to broaden its income tax base by eliminating widespread exemptions and the AMIR recommendations to stop giving tax incentives for new foreign investment without making changes to its international tax rules at the same time, the Jordanian income tax base would be better secured but the cost of capital for all Jordanian firms would rise.

7.5 Problems Taxing Residence Income Only

In international tax model 2:

- Non-residents who invest in Jordan pay no Jordanian income tax; and,

- Jordanian residents who invest offshore pay Jordanian income tax on all of their foreign income.

In other words, Jordan now taxes all income of Jordanian residents, regardless of whether it is earned in Jordan or offshore. This is pure residence taxation.

Non-residents

As non-residents who invest in Jordan do not have to pay any Jordanian income tax, they require a 10 percent rate of return to make an investment in Jordan. This 10 percent pre-tax rate of return also gives them their required 10 percent post-tax rate of return.

As Jordan does not impose any tax on non-resident investors, who are likely to be the marginal providers of capital in Jordan, the cost of capital in Jordan will be the same as the world rate. Put another way, interest rates in Jordan will equal the world rate of 10 percent.

Residents

Assuming Jordan broadens its income tax base by eliminating widespread exemptions, Jordanians would now pay 20 percent income tax on all of their business investment in Jordan.

As Jordan imposes 20 percent income tax whether Jordanians invest in Jordan or offshore, the 10 percent pre-tax rate of return becomes 8 percent after-tax in both cases.

As a result, the Jordanian income tax system no longer creates a tax incentive for residents to either invest onshore or offshore. The post-tax rate of return is the same 8 percent.

Implications

There would be three main implications for Jordan from this combination of income taxes in international model 2:

- The cost of capital in Jordan would be kept at the 10 percent world rate of return as Jordan would not tax non-residents who are in the marginal provider of capital in Jordan.

- The 10 percent rate of return on capital in Jordan might discourage saving in Jordan compared to international tax model 3;

- The tax incentive for Jordanian residents to invest offshore would have been removed;

- The Jordanian income tax base, which would now consist of tax raised on Jordanian residents investing onshore and offshore, would be better secured, although, in part, this would depend on how successful Jordan is in collecting taxes on its residents' offshore income, which exchange of information provisions in Jordan's DTAs are designed to help.

This combination of international income taxes is widely accepted in the economic literature to be the best policy for a small open economy that both imports and exports capital, like Jordan. From Jordan's national perspective, it would result both in a lower cost of capital for all Jordanian firms and a more efficient use of Jordanian resources. Jordanian residents would seek the highest pre-tax rate of return anywhere in the world. From an income tax perspective, Jordan's revenue from business investment would be better secured, although, in part, this would depend on how successful Jordan is in collecting taxes on its residents' offshore income, which exchange of information provisions in Jordan's DTAs are designed to help.

7.6 Appropriate International Tax Model for Jordan

In this section, we now briefly outline the 'economic rent' and 'foreign tax credit' exceptions that were temporarily left aside in the analysis in sections 7.2 to 7.5. We also outline the broad effect of Jordan's double tax treaties and some tax administration considerations. Further analysis of the weight to be given to each of these points in the case of Jordan will need to be undertaken in the comprehensive income tax review.

Analysis of the likely impact of the income taxes in the countries through which most foreign direct investment is likely to come to Jordan (Jordan's double tax treaty partners that offer foreign investors the lowest tax cost option of repatriating profit) will also need to be undertaken.

Neither these exceptions nor these practical considerations detract from the key insight of the theoretical analysis above: **the way that Jordan taxes residents on their foreign income and non-residents on their Jordanian income are linked. Jordan's income tax currently does not adequately consider the interaction between these two arms of international income tax policy, as well as their interaction with how Jordan taxes Jordanians on their investment in Jordan.**

The first question is to what extent there are 'supernormal' profits to be earned by non-resident MNEs in Jordan, perhaps from monopoly profits or exploiting natural resources. If most non-resident MNEs in Jordan are earning 'supernormal profits' in Jordan, Jordan can afford to impose higher income taxation on the income of non-residents without discouraging many of them from investing in Jordan. In terms of the see-saw principle outlined below, this would enable Jordan to impose slightly lower taxes on its residents' offshore income.

The second question about 'foreign tax credits' needs to be broken down into two parts. First, to what extent do non-resident MNEs invest in Jordan through and from countries that offer foreign tax credits? If, for example, Swedish investment in Jordan is typically routed through a country like France to get the benefits of the Jordan-France DTA, it is the French tax treatment of Jordan's income tax that is relevant. Of course, if the Swedish income tax system also attributes profits on the Jordanian investment to its Swedish beneficial owners, as it is earned in the Jordanian company, the Swedish tax treatment of Jordan's income tax is also relevant. Secondly, to what extent are non-resident MNEs that come from countries that offer foreign tax credits able in fact to claim a foreign tax credit for income tax paid in Jordan? In practice, many countries that offer a foreign tax credit impose so many limitations on it that many MNEs already hold excess foreign tax credits which they cannot use in their home country. If this is true of many MNEs operating in Jordan, the existence of a foreign tax credits should not be taken into account in deciding how to design Jordan's international income tax rules. If, on the other hand, many MNEs operating in Jordan can get a credit for Jordan's income tax, Jordan can afford to impose higher income taxation on the income of non-residents without discouraging many of them from investing in Jordan.

The third question relates to the broad effect of Jordan's double tax treaties and tax administration considerations on the design of Jordan's international income tax rules. The obligations in Jordan's double tax treaties mean that Jordan cannot impose pure source taxation, as in international tax model 3. Jordan's DTAs, for example, create a 'permanent establishment' threshold before Jordan is able to tax business income earned by non-resident from the treaty partner country in Jordan. Equally, Jordan's DTA obligations mean that Jordan cannot impose pure residence taxation, as in international tax model 2. Jordan's DTAs require it to either exempt income earned abroad by Jordanian residents or to provide a foreign tax credit. In terms of tax administration, the exchange of information provisions in Jordan's double tax treaties should assist Jordan apply its income tax law to more income earned offshore by its residents.

As a consequence, an appropriate mix of Jordanian income taxes on residents and non-residents is likely to be somewhere in the middle between source and residence taxation (international tax models 2 and 3).

A further insight from the economic literature is that the appropriate combination of taxes for a small open economy is like a see-saw:

- if taxes on *residents* are low, then taxes on *non-residents* should be high; or
- if taxes on *residents* are high, then taxes on *non-residents* should be low.[51]

This still leaves each country considerable room to design different combinations of international tax rules. As we have seen in discussing the theoretical international tax models 2 and 3 above, one of the key trade-offs, at the margin, is between increasing investment (the residence international tax model 2) and increasing incentives to save (the source international tax model 3 above).

If the Jordanian government decides that its key objective is to increase investment in Jordan by lowering the cost of capital in Jordan for all Jordanian firms, it should move its income tax system more towards residence taxation. The first place to start is a review of the problematic Article 3 (B) that was extensively analysed in section 4.2. The extent to which Jordan should move towards residence taxation depends on the answers to 'economic rent' and 'foreign tax credit' questions asked above in this section.

Is Jordan were to move more towards residence taxation, a broad group of Jordanians who found employment and who earned higher incomes from any increase in investment would benefit. A relatively small number of publicly listed Jordanian companies who cannot hide their offshore investments from the Jordanian Income Tax Department would complain that the new approach made them uncompetitive in relation to other firms from other countries. Their complaints would be likely to focus on statutory income tax rates in various countries and the effect of taxes on their cash flows. They would not take into account the offsetting effects of the lower cost of their capital resulting from the policy.

We reiterate the point that we made at the beginning of this section. Jordan needs to take considerable care in formulating its international tax policy. It needs an economic framework within which it can begin developing and implementing policy incrementally and monitoring the effects of each reform as it is made. It will need to consult widely and to sell its reforms to business.

[51] Slemrod, J., Hansen, C. & R. Procter (1994) "The Seesaw Principle in International Tax Policy," NBER Working Paper No. 4867, Mass: NBER.

8. Future Work

8.1 Introduction

Jordan registered a fiscal surplus of 1.8 percent of GDP in the first quarter of 2004. After the IMF Executive Board approved the Third Review under the Stand-By Arrangement for Jordan, Anne Krueger, First Deputy Managing Director, both complimented Jordan on this performance and then noted its future work.

> *The remarkably strengthened fiscal position in the first quarter of 2004 is the result of strong revenue measures and reforms implemented earlier and a manifestation of the authorities' resolve to contain budgetary outlays, notwithstanding large grant inflows. The package of revenue measures implemented in April will further strengthen fiscal performance in 2004.*
>
> *…Jordan continues to face challenges over the medium term, in the form of a high debt burden, dependence on external grants, and vulnerability through higher oil prices. Achieving the debt limits under the Public Debt Law by 2006 will require sustained fiscal consolidation including elimination of subsidies on petroleum products, comprehensive reform of the direct tax system, and expenditure rationalization. In this context, the substantial reduction in government debt recorded so far in 2004 and the government's track record on fiscal consolidation is encouraging*[52]

For reasons explained throughout this report, this consultancy agrees that comprehensive reform of Jordan's income tax system is a top priority for Jordan, to increase both the revenue it collects and the growth it achieves from opening its economy.

8.2 Jordan's Income Tax Policy

The first step in the future work program should be to design an income tax policy that raises the required revenue at the lowest economic cost: compliance costs, administrative costs and the costs of tax-driven behavior. Good tax policy that raises revenue while reducing these costs will help Jordan achieve its broader growth and employment goals**.**

Jordan's income tax system should not merely aim at collecting the revenue government requires. The objective should be to collect revenue in the best possible way. Tax changes that merely respond to the government's immediate revenue requirement or business' current concerns will result in an incoherent system that diverts taxpayers from productive activity towards tax planning to avoid paying tax.

Section 7 briefly illustrated how to think about an appropriate combination of taxes on the cross-border business income of residents and non-residents for a small open economy, like Jordan, which both imports and exports capital. It emphasized the link between the taxation of Jordanians' investment overseas and foreigners' investment in Jordan. It showed why Jordan's taxation of Jordanian investment in Jordan is also relevant. It explained how good international income tax policy can help protect Jordan's income tax

1. [52] IMF, "IMF Executive Board Completes Third and Final Review Under the Stand-By Arrangement with Jordan", Press Release No. 04/136, 6 July 2004, p1-2. Available at <http://www.imf.org/external/pubs/ft/scr/2004/cr04287.pdf> at p 53.

revenue base, keep Jordan open to beneficial cross-border investment and keep the cost of capital to firms in Jordan as low as possible.

8.3 Jordan's Income Tax Law

The second step in the future work program should be to draft income tax law that raises the required revenue at the lowest economic cost: compliance costs, administrative costs, and the cost of tax-driven behavior. In other words, good tax law, like good tax policy, must make its contribution towards reducing the costs of collecting the required amount of revenue for the Jordanian Government.

The most recent IMF mission report notes, "The income tax legislation has been strengthened, albeit to a limited extent."[53] We were unable to identify such improvements in the drafting of Jordan's international income tax rules. In section 4, we identified some of the problems of a conceptual and drafting nature with Jordan's ITL. These problems impose a very high costs on investors in seeking tax advice and, inevitably, negotiating each year's tax return with the Jordanian Income Tax Department.

Another area for future work in relation to income tax law should be to improve public access to it. Jordanian income tax law consists of Jordan's Income Tax Law, regulations, instructions, double tax treaties, and formal decisions made under income tax law by the Council of Ministers, the Minister of Finance, the Director-General of the Income Tax Department and departmental officials.

At present, even businesspeople and tax advisers in Amman complain about the difficulty of getting prompt access to some Jordanian income tax law. The release to a member of the public of a new Jordanian DTA that had entered into force, we were told, had required the approval of the Director-General of the Income Tax Department.

The websites of the Income Tax Department and the Jordanian Embassy in Washington, DC, for example, do not have up-to-date versions of Jordan's Income Tax Law. The Income Tax Department website does not contain any of Jordan's DTAs.

One of the most comprehensive DTA databases in the world, which is used by many international tax practitioners around the world, is out-of-date in respect to Jordan. It records that Jordan currently has 11 DTAs in force (in fact, Jordan has 17). It publishes the text of 10 of those 17 DTAs only. Finally, to obtain the non-English DTA texts of another 4 of Jordan's DTAs (those in Arabic and Polish), it is necessary to contact the organisation and pay 50 Euro for a copy of that Arabic or Polish DTA text.[54]

To reduce the costs of determining obligations under Jordan's income tax law, cheap, easy and reliable access to all of Jordan's income tax law, including its DTAs, both by Jordanians and foreigners alike, is essential.

[53] International Monetary Fund, *Jordan: Third Review Under the Stand-By Arrangement; and Press Release on the Executive Board Discussion*, September 2004, IMF Country Report No. 04/287 at p 34, available at <http://www.imf.org/external/pubs/ft/scr/2004/cr04287.pdf>.

[54] The International Bureau of Fiscal Documentation in Amsterdam, the Netherlands. The database is called *Tax Treaties Database*.

Further, if Jordan seeks most of its investment in the next 20 years offshore and seeks to tax that investment even lightly, Jordanian income tax law should be published promptly in Arabic and in a major international business language used by many of those foreign investors, which presumably would be English. Indeed, English is the most used language for the world's tax agreements – used either as a negotiation language, an authentic treaty language or as a translation language.

Government websites that publicise Jordan's income tax law, like the Income Tax Department website, should publicise up-to-date law, including DTAs. Copies of DTAs, preferably including a translation into English, should be sent promptly to important DTA databases that many international tax practitioners consult, like that *Tax Treaties Database* run by the International Bureau of Fiscal Documentation in Amsterdam, the Netherlands and the *Worldwide Tax Treaties* run by Tax Analysts in Arlington, Virginia, USA.[55]

8.4 Jordan's Income Tax Administration

As was true for income tax policy and income tax law, the objective of good tax administration is to raise the required revenue at the lowest economic cost: compliance costs, administrative costs, and the cost of tax-driven behavior.

The Jordanian Ministry of Finance is currently working to improve the efficiency and effectiveness of Jordan's revenue administration.[56] Among the other things, it is developing a Large Taxpayer Office administration within the unified Revenue Department. This should help Jordan administer its international income tax law. If Jordan seeks most of its investment in the next 20 years offshore and seeks to tax that investment even lightly, Jordan will need well-trained administrators, who can deal with complex issues involving the interaction between Jordan's income tax system, Jordan's double tax treaties and the income tax systems of third countries.

DTAs are expensive instruments to negotiate and administer. All the steps that are necessary to negotiate good DTAs are well illustrated in Appendices 13 and 15. Appendix 15 sets out valuable procedural suggestions for negotiating good DTAs. It is an extract from the 2003 edition of the *UN Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*. Appendix 13 sets out a national interest analysis prepared by the New Zealand Inland Revenue Department for the Finance and Expenditure Committee of the New Zealand Parliament. The trade, investment, and tax analysis explains to New Zealand members of Parliament why, on balance, it is in New Zealand's interest to enter into a DTA with the United Arab Emirates. It is a good illustration of the cost benefit analysis that should be done in deciding whether it is in a country's interest to begin negotiating a DTA and in deciding whether to implement the treaty that has been negotiated. Even where it is not possible to be precise about monetary costs and benefits, it does attempt to make the best judgment about all of the costs and benefits.

[55] See <http://www.taxanalysts.com>.
[56] International Monetary Fund, *Jordan: Third Review Under the Stand-By Arrangement; and Press Release on the Executive Board Discussion*, September 2004, IMF Country Report No. 04/287 at p 50, available at <http://www.imf.org/external/pubs/ft/scr/2004/cr04287.pdf>.

At present, Jordan uses considerable human and financial resources to negotiate a relatively large number of double tax treaties. The Income Tax Department has four staff dedicated to double tax treaty negotiation and administration. This unit, and the more senior staff it reports to, will be responsible for contacts with tax administrators from other countries, dealing with requests for DTA negotiations, making preparations for negotiations, negotiating DTAs (generally, in two rounds, one at home, and one abroad), implementing DTAs in Jordan, and administering treaties.

Unfortunately, this unit is not adequately resourced in comparison to some of the foreign DTA teams with whom they must negotiate. This puts Jordan at a considerable disadvantage in the negotiations. Jordan's negotiators need the following resources to be able to prepare adequately to negotiate good DTAs that advance Jordan's national economic interests:

- Regular training on interpreting and administering double tax treaties, which in most cases will require travelling to courses overseas;

- Up-to-date resources on international tax and double tax treaty developments, including books, subscriptions to select international tax journals, electronic and online DTA data sources;

- A desk computer with access to the Internet to do research on other country's income tax systems using online sources;

- An annual subscription to a comprehensive tax treaty database like Tax Analysts' *Worldwide Tax Treaties* or the International Bureau of Fiscal Documentation's *Tax Treaty Database*;

- A laptop computer that Jordan's DTA negotiators can take to negotiations overseas with a comprehensive tax treaty database, so that Jordan's negotiators can quickly research other countries' DTAs to find legal precedents for the position that they are advancing in the negotiation.

Implementing these suggestions will be expensive but that is one of the main points that this consultancy is making. DTAs are an expensive solution to cross-border tax issues. If DTAs are the only solution to major cross-border issues from a national Jordanian perspective and they will produce a clear net benefit to Jordan, a case can be made for this expenditure to be considered alongside all the other expenditure requirements in collecting Jordan's revenue. If Jordan decides to negotiate and implement a DTA, the negotiation and ongoing 20 to 30 year administration of a DTA should be fully resourced. Jordan is not doing that at present.

9. Conclusions and Recommendations

9.1 Net Benefits of a Jordan-US Double Tax Treaty

1. **Given Jordan's present international income tax rules, each DTA that Jordan negotiates represents a net economic loss viewed from Jordan's national viewpoint.** This is true even if the potential treaty country is one of Jordan's major trade and investment partners, the United States.

2. Given Jordan's present international income tax rules, **the costs to Jordan of each DTA that Jordan negotiates are**:

    - **Jordan gives away income tax revenue.** Jordan largely taxes only income earned in Jordan and all of Jordan's DTAs reduce its right to tax that income. There is no offset for Jordan, as there is for countries that tax their residents on their foreign income, like the United States. Each of Jordan's DTAs gives Jordan greater taxing rights in relation to the foreign income of its residents. Jordan largely chooses not to exercise those rights in its domestic tax law;

    - **Jordan accepts responsibility to help one more country administer its tax system and gets little or no help in return**, as Jordan's income tax is largely territorial and Jordan does not need other countries' help to enforce taxation of economic activity that occurs in Jordan;

    - **Jordan does not immediately open the gates for foreign investment from that country**, as Jordan itself has found in the last 20 years. Recent economic research in the United States suggests other countries may share this experience. Using both US and OECD foreign direct investment (FDI) investment data, empirical research suggests that negotiating new DTAs is not very likely to increase FDI between the DTA partners and may actually decrease it for a period;

    - **Jordan is likely to make the task of reforming its international income tax rules more difficult**, as DTAs are not based on good tax policy principles, and the slightly different concessions made to achieve agreement in each DTA may make some reform options more difficult; and,

    - **Jordan diverts scarce resources from more pressing tax matters to negotiating, monitoring, maintaining and administering DTAs** (see sections 5 & 6);

3. **A specific additional cost in relation to negotiating a DTA with the United States may arise for Jordan as** Jordan will need to consider whether it is prepared to modify its banking confidentiality policy, at least in respect of 'tax fraud', as Switzerland and Luxembourg have been prepared to in order to have a DTA with the United States, and what the cost of that would be in terms of its objective of projecting Amman as an important financial center in the region (see recommendations 22 and 23, as well as sections 2.5 & 3.2).

4. Given Jordan's present international income tax rules, **there are limited benefits for Jordan's national perspective from each DTA that Jordan negotiates, with the main one being that a DTA is a part of the overall legal framework that governs cross-border investment and provides investors with mechanisms to resolve tax disputes and issues.** To the extent that US investors have a tax holiday for their investment in Jordan and adopt a simple investment structure, they should have little contact with the Jordanian income tax system. To the extent that US investors are taxable on their investment in Jordan now or in the future, they would have contact with the Jordanian income tax system and a DTA would provide a greater level of certainty in relation to their tax treatment and a mechanism for dealing with tax disputes and issues (see section 5.4).

5. **On balance, it is clear that the first priority for Jordan is to reform its income tax policy, including taxation of cross-border income before considering negotiating a DTA with the United States. The major cause of tax issues for cross-border investment between the United States and Jordan is Jordan's income tax law and administration.** The most appropriate way of resolving these problems is to review and reform Jordan's income tax policy, law and administration (see section 4.1 & 4.2).

6. While some Jordanian investors in the United States raised issues concerning US branch profits and withholding tax rates, **US empirical research suggests that reducing withholding tax, through negotiating a DTA, for example, does not increase foreign direct investment by US firms.** Consistent with these research findings, many countries in the world continue to impose taxes and withholding obligations on dividend repatriations and dividend distributions to shareholders. Jordan, on the other hand, has recently stopped deducting non-resident withholding tax on dividends (see section 4.3).

7. Given that each DTA that Jordan is currently negotiating provides a net economic loss to Jordan and there are major problems with Jordan's income tax**, Jordan should suspend its double tax treaty negotiating program while it commences a comprehensive review of its income tax system and its double tax treaty program. During this period of suspension, however, there may be some maintenance that Jordan needs to do on its existing DTAs** (see section 6.2 and recommendation 15 below).

8. **Jordan's senior and experienced tax policy, law and administration staff must be involved in this comprehensive income tax review.** The opportunity cost of scarce tax policy and administration staff in Jordan's Income Tax Department negotiating many DTAs when a comprehensive tax review is so pressing is large (see the list of current DTA negotiations in appendix 6). In addition, the danger in attempting to negotiate so many DTAs at the same time is that some provisions in them will undermine Jordan's income tax policy and revenue objectives immediately, or at some time in the next 20-30 years before the DTAs are renegotiated.

9.2 Review of Jordan's Income Tax Policy, Law and Administration

9. This consultancy recommends that **a comprehensive review of Jordan's income tax policy, law and administration should be an urgent priority for government.** The

reduction of Jordan's company and individual income tax rates was the easy part of reform. Broadening Jordan's income tax base and deciding how to tax cross-border income will be far more difficult exercises. **Yet, if Jordan does not get its income tax reforms right, it will greatly reduce the benefits that will flow from opening its economy to international capital flows in the first place.** Jordan's income tax rules are a key policy lever to ensure both foreign and Jordanian private investors face trade-offs that echo the relative costs and benefits from Jordan's national perspective (see section 7).

10. This consultancy raised a large number of international tax policy, law and administration issues that should be considered by a comprehensive review of Jordan's income tax (see section 4).

11. The consultancy report shows how Jordan taxes residents on their foreign income and non-residents on their Jordanian income are linked. Jordan's income tax currently does not adequately consider the interaction between these two arms of international income tax policy, as well as their interaction with how Jordan taxes Jordanians on their investment in Jordan. We recommend that Jordan review its international tax policy (how it taxes residents on their offshore income and non-residents on their Jordanian income) before, or at the same time as:

    - Jordan undertakes any major base broadening in terms of how Jordan taxes income from domestic investment by Jordanians;

    - Jordan reformulates its tax incentive program (see section 7);

12. We recommend that Jordan seriously considers the merits of moving more towards residence income taxation in a more coherent way than Jordanian Income Tax Law currently does in Article 3 (B) (see section 4.2.a, and section 7, particularly 7.5 & 7.6).

13. We recommend that Jordan review its decision not to levy non-resident withholding tax on dividends. US empirical research suggests that reducing withholding tax, through negotiating a DTA, for example, does not increase foreign direct invetment by US firms. Consistent with these research findings, many countries in the world continue to impose taxes and withholding obligations on dividend repatriations and dividend distributions to shareholders on dividends.

9.3 Review of Jordan's Double Tax Treaty Program

14. Once Jordan determines and implements its medium-term income tax strategy, a cross-border tax problem policy can be developed that uses unconditional and conditional unilateral measures in domestic law, as well as double tax treaties. That cross-border tax problem policy must work with Jordan's income tax law and administration to advance Jordan's economic objectives. Income tax law and double tax treaties can then complement each other in working for the same broad objective of raising the required amount of income tax revenue for Jordan at the least net economic, compliance and administrative cost and in a fair manner. (section 5).

15. Jordan should immediately review whether its DTA with Malaysia should extend to persons carrying on any offshore business activity under the Labuan Offshore Business Activity Tax Act 1990, given the problems that this is causing other countries, like Korea (see section 6.2).

16. Once Jordan develops its double tax treaty policy, it should focus on negotiating a smaller number of 'good' DTAs with key investment partners to solve tax issues that cannot be resolved by amending Jordan's domestic tax law.

17. Jordan should develop double tax treaty processes that involve more private and public sector involvement in the choice of DTA partners, as well as identifying cross-border tax issues and solutions. Double tax treaties are not just about a 'tax', or even 'double tax'. They can have broader economic and foreign relation effects.

18. The process of negotiating, monitoring and renegotiating double tax treaties should be the responsibility of a number of agencies, not just the Jordanian Income Tax Department. Jordanian agencies with responsibilities for public finance, economic development and foreign policy should be involved in recommending to Jordanian ministers prioritisation of DTA negotiations, the parameters for Jordan's DTA negotiators and in providing ministers with a broad interdepartmental assessment of the costs and benefits of implementing the double tax treaty text that has been negotiated. Jordan is much less likely to achieve the economic objectives it sets for its DTAs, if the same, small group of bureaucrats alone advises ministers on the choice of DTA partners, the cross-border tax issues, the negotiating brief and the outcome of negotiations.

19. As officials can never have a full appreciation of the tax and investment issues facing cross-border investors, it is advisable to seek participation by cross-border investors and their organizations, like the Jordanian American Business Association (JABA) in the case of the proposed Jordan-US DTA. The private sector can help identify just how the existing income tax law and administration in the two countries is creating issues for investment and trade. Jordanian officials should consult the private sector before making their recommendations to ministers on the priority of DTA negotiations and in analyzing the exact nature of a cross-border tax issues for investment between Jordan and another country.

20. If one main reason for Jordan negotiating double tax treaties is to attract foreign investment, it should give greater publicity to its DTA program and treaties. The text of all treaties should be publicly available. All double tax treaty texts should appear on the Income Tax Department website in their original languages. Indeed, they might also be translated into a major business language, like English, to maximize their readership.

21. Jordan has also been negotiating DTAs with a number of other countries that seek to provide a treaty conduit between foreign investors from third countries and a host investment country, like Jordan. Jordan should examine very carefully the text of the DTA that it has signed but not yet implemented with Malta and its interaction with Malta's tax law and be cautious in relation to the DTA negotiation proposal it has

received from Cyprus and its interaction with Cyprus tax law,[57] notwithstanding their commitments to the OECD in relation to harmful tax competition. The royalty provisions in the Jordan-Netherlands DTA[58] and in the Switzerland DTA proposal, in particular, are also matters to review (section 6.2).

22. Jordan's DTA negotiators should be given the following resources to be able to prepare adequately to negotiate good DTAs that advance Jordan's national economic interests:

- Regular training on interpreting and administering double tax treaties, which in most cases will require traveling to courses overseas;
- Up-to-date resources on international tax and double tax treaty developments, including books, subscriptions to select international tax journals, electronic and online DTA data sources;
- A desk computer with access to the Internet to do research on other country's income tax systems using online sources;
- An annual subscription to a comprehensive tax treaty database like Tax Analysts' *Worldwide Tax Treaties* or the International Bureau of Fiscal Documentation's *Tax Treaty Database*;
- A laptop computer that Jordan's DTA negotiators can take to negotiations overseas with a comprehensive tax treaty database, so that Jordan's negotiators can quickly research other countries' DTAs to find legal precedents for the position that they are advancing in the negotiation.

9.4 Jordan-US DTA

23. Once Jordan has developed its international tax and DTA policy, Jordan should first hold preliminary discussions with US Treasury representatives on exchange of information, particularly bank information. As this report outlined, the United States is even more committed to exchange of information, including bank information, than it was 20 or 30 years ago, when it started negotiating double tax treaties with countries in the Middle East and North Africa region. Having said that, the United States has been prepared to accept less extensive exchange of information provisions than its US Model DTA requires. It needs to be emphasised, in the words of the United States Treasury Department, that the US Model DTA "is not intended to represent an ideal United States income tax treaty. Rather, a principal function of the model is to facilitate negotiations by helping the negotiators identify differences between income tax policies in the two countries."

[57] Rigby, M, "A Critique of Double Tax Treaties as a Jurisdictional Coordination Mechanism" (1991) 8 *Australian Tax Forum* 303-423 at 422. Rigby describes Cyprus as "a recent example of a country that has set itself up as a treaty conduit in a way that abuses source country interests." He briefly describes the three features of Cyprus tax law that enable Cyprus to achieve that objective.

[58] Rigby, M, "A Critique of Double Tax Treaties as a Jurisdictional Coordination Mechanism" (1991) 8 *Australian Tax Forum* 303-427 at 423. Rigby describes how the Netherlands has set itself up as a treaty shopping conduit for one type of income, namely royalty payments.

24. Other countries with bank secrecy laws, such as Switzerland and Luxembourg, have been able to find solutions that satisfied their banking secrecy policies and laws and the US DTA exchange of information requirements (see section 3.2 and appendix 9). Jordan should investigate further whether it can at least agree to exchange bank information in relation to tax fraud, as Switzerland and Luxembourg have agreed with the United States. The experience of some other countries with bank secrecy laws has, however, been that the negotiations over the precise scope of the exchange of information obligation has been drawn out. As a result of the US constitutional system, it is not only the US Administration that will need to agree to Jordan's proposals but also the US Senate, particularly its Committee on Foreign Relations.

25. The US Senate's unwillingness to give a foreign tax credit for tax spared by Jordanian tax incentives may not be a major issue if Jordan accepts the recommendations of the AMIR tax incentive consultancy report to begin dismantling the existing Jordanian tax incentive program.

Annexes

Annex 1 Scope of Work

Short Term Consultancy Agreement Scope of Work

Activity Name:	531.02 Support to Foreign Trade Policy Directorate
SOW Title:	Assessment of Net Benefits of Double Tax Agreement with the United States
Modification No:	Original
SOW Date:	May 6, 2004
SOW Status:	Draft
Task and Consultant Name:	F/Assessment of Net Benefits of Double Tax Agreement with the United States

I. Specific Challenges to Be Addressed by this Consultancy

Jordan has taken concerted measures to promote its bilateral commercial relations with the United States through the establishment of the Qualified Industrial Zones (QIZs), the conclusion of the Bilateral Investment Treaty (BITS), the Trade and Investment Framework Agreement (TIFA), and the signing and ratification of the Jordan-US Free Trade Agreement (JUSFTA). Consistent with Jordan's other trade and investment policy reforms, such initiatives seek primarily to increase Jordan's exports and inflows of foreign investment, including US investment. A further tool that could facilitate trade and investment is still missing, namely a double taxation agreement (DTA).

In December 2002 International Business Legal Associates (IBLAW) completed a brief report noting the implications for Jordan of the main elements of the US model tax treaty. It concluded that a DTA should be considered if double taxation of income and capital flows between the United States and Jordan is an obstacle to greater trade and investment. It noted that any evaluation of a specific DTA proposal should involve weighing its specific advantages to trade and investment against any fiscal and non-fiscal challenges that may be involved. The report noted that non-fiscal costs of a DTA could require the Jordanian tax authority to provide information about Jordanian taxpayers, at the request of US tax authorities, even if Jordanian law does not permit the collection of such information. It is the understanding of the USAID-funded AMIR Program that the Council of Ministers relied upon a perception that a DTA would involve undue disclosure of financial information to US tax authorities when deciding not to proceed with a DTA. The USAID-funded AMIR Program has sought the opinion of an external taxation expert who suggests that there is little risk of Jordanians being subject to arbitrary and undue financial disclosure under a DTA with the United States. Moreover, without a full understanding of the potential costs and benefits of a DTA it is difficult to determine whether a DTA is in Jordan's national interests.

Two recent developments strengthen the case for assessing the benefits of a DTA. Firstly, the AMIR Program is undertaking a review of investment incentives in the Kingdom, to be completed by the end of May. A DTA review will be able to build on the incentives study to highlight the interaction between a DTA and investment incentives. It should be noted that US DTA policy does not provide for tax sparing, i.e. income earned by US investors in Jordan and taxed at reduced rates through an incentive scheme in Jordan will be fully taxable in the United States when repatriated to the United States. In

effect, by foregoing the right to tax income under an income tax holiday, Jordan transfers this tax revenue to the United States Treasury.

Secondly, as a condition precedent of the US cash transfer program, the Ministry of Finance is drafting terms of reference for a comprehensive review of taxation in Jordan. Given the volatility of international capital flows, international tax theory suggests that international tax policy should set overall parameters for domestic tax policy. A focused look at Jordan's international tax policy and use of DTAs will be able to inform and provide some guidance to the eventual comprehensive tax review. At this time it is not clear when the comprehensive review will be undertaken.

II. Objective of this Consultancy

The objective of this consultancy is to assess the net benefits to Jordan of negotiating a double tax agreement with the United States.

III. Specific Tasks of the Consultant

Under this Scope of Work, the Consultant shall perform, but not be limited to, the specific tasks specified under the following categories:

A. **Background Reading Related to Understanding the Work and Its Context**.

The Consultant shall read, but is not limited to, the following materials related to fully understanding the work specified under this consultancy:

- Income Tax Law 1985 as amended.
- *A Jordan-US Double Tax Agreement: What Would it Involve? How Would it Work?,* prepared by IBLAW for the AMIR Program, December 2002.
- US Model DTA and relevant US DTAs.
- Recent Jordanian DTAs.

B. **Background Interviews Related to Understanding the Work and Its Context**.

The Consultant shall interview, but is not limited to, the following individuals or groups of individuals in order to fully understand the work specified under this consultancy:

- Greta Boye, Team Leader, Private Sector Policy Initiative (PSPI), AMIR Program
- Geoff Wright, Manager, Trade Policy and Market Access Subcomponent, AMIR Program
- Relevant officials at Ministry of Finance and Income Tax Department, to be determined
- Accounting firms in Jordan, to be determined

C. **Tasks Related to Accomplishing the Consultancy's Objectives**.

The Consultant shall use his/her education, considerable experience and additional understanding gleaned from the tasks specified in A. and B. above to:

1. Review current Jordanian international tax law, including its existing DTA network.
2. Review the current DTA policy of the United States, examining relevant DTAs that the United States has negotiated.
3. Examine available data on income and capital flows between the two countries.
4. Identify and assess the nature of any past, existing or potential instances of double taxation or other barriers to trade and investment between the two countries due to the respective tax treatment in each country.
5. Discuss how a DTA could ameliorate these barriers.
6. Note any constraints that Jordan's DTA network, and a potential DTA with the United States, could place on Jordanian tax policy makers.
7. Briefly, suggest an appropriate international tax regime for Jordan based on its characteristics as a small, capital importing country, including the role of DTAs.
8. Recommend future work that should be undertaken with respect to DTA and international tax policy in Jordan and also with respect to the proposed comprehensive tax review.

The substance of, findings on, and recommendations with respect to the above mentioned tasks shall be delivered by Consultant in a written report in the format described in sections IV., V., and VI. Of Annex A – Standard Short Term Consultancy Agreement Information.

IV. Time frame for the Consultancy.

Unless otherwise specified in writing, the time frame for this consultancy is specified by the expenditure start and end dates shown in Annex C.

V. LOE for the Consultancy.

The days of level of effort are allocated by location in Annex C.

VI. Consultant Qualifications.

The Consultant shall have the following minimum qualifications to be considered for this consultancy:

Educational Qualifications

- PhD or equivalent in law, economics or finance with specialty in international taxation.

Work Experience Qualifications

- Experience negotiating DTAs.
- Experience formulating and recommending international tax policy to senior government decision makers.

Annex 2 Individuals Consulted

Sean Jones	Deputy Director	Office of Economic Opportunities, USAID/Jordan
Jamal Al-Jabiri	Cognizant Technical Officer	Office of Economic Opportunities, USAID/Jordan
Greta Boye	Team Leader	Private Sector Policy Initiative (PSPI), AMIR Program, Amman
Geoff Wright	Manager	Trade Policy and Market Access Subcomponent, AMIR Program, Amman
Randa Muasher	Business Management Specialist	AMIR Program, Amman
Eyad Kodah	Director General	Income Tax and General Sales Tax Departments, Amman
Omar T. Abu-Salhieh	Conventions Section	Income Tax Department Amman
Ali Misned	Conventions Section	Income Tax Department, Amman
Wolfgang Schaf	Advisor	Ministry of Finance, Amman
Omar Ahmad Ali	Reform Coordination Manager	Ministry of Finance, Amman
Dawood Al-Ghoul	Head of Global Taxation	Arab Bank, Amman
Khaled Asfour	Partner	Zu'bi and Co, Amman
Mansour Haddadin	Consultant	Tax Experience House, Former Director General of Income Tax Department, Amman
Bassam Kanaan	Chief Financial Officer and two staff members	Hikma Investment, Amman
Samir Abu Lughod	Managing Partner	Ernst & Young, Amman
Nadim Kayyali	Corporate Attorney	Microsoft Middle East and North Africa, Amman
Oliver Oldman	Learned Hand Professor of Law Emeritus	Harvard Law School, Boston, Massachusetts, USA
Robert Bordone	Thaddeus R. Beal Lecturer on Law and the Deputy Director of the Harvard Negotiation Research Project (HNRP)	Harvard Law School, Boston, Massachusetts, USA
Roger Fisher	Director of the Harvard Negotiation Project,	Harvard Law School, Boston, Massachusetts,

	Samuel Williston Professor of Law Emeritus	USA
Daniel Halperin	Stanley S Surrey Professor of Law	Harvard Law School, Boston, Massachusetts, US
Alvin Warren	Ropes & Gray Professor of Law	Harvard Law School, Boston, Massachusetts. USA
Michael Keen	Fiscal Affairs Department	IMF, Washington, DC USA
Maher S. Maltalka	Director, Economic & Commerce Bureau	Embassy of the Hashemite Kingdom of Jordan, Washington DC USA
Stephen E. Shay	Tax Partner	Ropes & Gray, Boston, Massachusetts, USA, former International Tax Counsel, U.S. Department of the Treasury, 1986-87
Leonard B. Terr	Tax Partner	Baker & McKenzie, Washington DC, former International Tax Counsel of the U.S. Department of the Treasury, 1987-89
Peter S. Watson	President	Overseas Private Investment Corporation, Washington DC USA

Annex 3 Documents Read During Consultancy

Income Tax Law 1985 as amended.

'A Jordan-US Double Tax Agreement: What Would it Involve? How Would it Work?', prepared by IBLAW for the AMIR Program, December 2002.

US Model DTA and relevant US DTAs.

Recent Jordanian DTAs.

Books and articles referred to in the endnotes and footnotes.

Annex 4 Extracts from the 2002 Investor Roadmap of Jordan

Executive Summary[59]

Operating
Operating procedures such as payment of corporate taxes and importing goods through customs typically are problematical for the private sector, and in Jordan they are no exception. In every instance where problems were identified taxation and customs ranked high on the list of negative reactions. However, it must also be emphasized that Customs procedures are commonly acknowledged to have improved significantly over the last three years to the extent that Customs itself is no longer the subject of extensive complaints. Delays encountered in clearing Customs are now mainly attributable to inspections by the Ministry of Health or the Jordanian Institute for Standards and Metrology. The most critical issues in relation to tax and Customs are as follows:

• **There is a palpable sense of mistrust between the Income Tax Department and the taxpaying public**. A consequence of this is that taxpayers deliberately underreport their income in many cases in the certain knowledge that their returns will be assessed for more tax. Tax assessors, who themselves are often not knowledgeable about the law or the regulations audit every return (this system is scheduled to change to audits based on risk assessment beginning in the tax year 2002, although there are doubts that it will be successful), and taxpayers are consistently confronted with demands for payment of what are sometimes outrageously high assessments. In the event that they do not, or cannot pay, the only alternative is to go to Court, where cases are heard before Judges who are equally unknowledgeable about the tax law.

• The law includes too many exclusions, the tax rates may be too low, and too much power is granted to the Director of Income Tax. The situation with regard to personal taxes also needs to be adjusted, as there are too many deductions, too many exclusions, and too many ways for rich Jordanians to avoid payment of taxes. Sales tax also has problems – it operates neither like a Value Added Tax, which it purports to be (but is not) or like a General Sales Tax. As such, the indications are that it will be **necessary to develop a new Income Tax Law**. Development of a new law would be preferable to making piecemeal changes to the current tax law, which has been changed multiple times over the years and is still not considered a good law. To change the current mindset where avoidance of taxation is considered acceptable, it may be necessary for His Majesty the King to set the tone for the country. For example, it may be beneficial if the King began paying taxes on the Royal Family's income (as is the case in other countries such as the United Kingdom) as an example of the need for compliance.

• There are no Jordanian accounting standards – international accounting standards are used – and this also needs to be remedied to ensure compliance by Jordanian accountants. As such, there is a **need to create a new Accountancy Law.**

• **Also needed will be a restructuring of the Income Tax Department**, the development and implementation of new procedures, an extensive training program for tax inspectors, and the development of greater trust between the public and the private

[59] AMIR, *The 2002 Investor Roadmap of Jordan Final Report* December 9, 2002, - pp12-14 at p14.

sectors in the area of taxation through an extensive public relations program which would concentrate on getting information out to the public. At the same time it will be essential to reeducate taxpayers in Jordan that payment of taxes due is essential to the public well being.

• However, these reforms cannot be put in place immediately without further study. As such, it is recommended to initiate a study that would examine current tax policy, tax administration, tax enforcement, and the revenue effects of changes to the tax system. In all likelihood, changes to the tax regime would yield a higher level of revenue to the treasury and remove unnecessary stress on both the public sector and the private sector. This would be an essential first step, and, in addition to a review of the system by consultants who are knowledgeable in all of these fields of taxation, the essential outcome of such a study would be very well-developed Terms of Reference for a multi-year tax reform program that would involve a new tax law, and a total restructuring of the Tax Department.

• Double taxation agreements are currently in force between Jordan and some 16 countries and being negotiated with others, but, despite the existence of a Free Trade Agreement, not with the United States. **There is a need to develop a double taxation agreement between Jordan and the U.S.**

Chapter 5: Operating[60]

Develop a Double Taxation Agreement with the United States. Double taxation agreements are in place between Jordan and several other countries, including European countries and Canada, but not with the U.S. It is surprising that this has not yet been done, given the prominence afforded to the US-Jordan Free Trade Agreement.

Chapter 6: Next Steps[61]

Given Jordan's efforts to actively encourage foreign direct investment (FDI) and diversify its economy to create badly needed jobs, it is appropriate to assess from time to time the general administrative climate under which investors – both local and foreign – will operate. With the Kingdom's commitment to opening the economy for
FDI, much can be achieved by further liberalizing the barriers that may detract from its appeal as a location for FDI.

Implementing administrative and procedural change in some cases can be accomplished with a minimal outlay of resources. In few cases will an agency need to purchase new equipment or supplies, hire new staff, or physically relocate offices. This does not mean, however, that streamlining bureaucracy through improving systems and procedures is easy. Indeed, it is often a difficult task to accomplish

largely because it requires strong political will among the leaders of an organization and a fundamental commitment among the implementing personnel to try new ways of doing things.

[60] Ibid, pp148-183 at 169.
[61] Ibid, pp209-214 at 214.

The first step toward improving administrative procedures in Jordan today has been accomplished by the creation of this diagnostic report. Not only does this report seek to describe the types of constraints investors face in Jordan, it also offers recommendations for consideration by the Government of Jordan. Through attempts to validate the procedural descriptions as part of the project's research phase, this document also presents a consensus-based description of the major procedures that an investor must go through to start up and operate a business in Jordan, and as such can serve as the base for any paper or web-based procedural guides that the government elects to produce.
…

E) Quick Wins

Finally, other important and positive changes could be made if the regulators involved made decisions to modify a current policy. As noted above, political will should be marshaled to encourage regulators to implement these changes. The procedural changes involved may require some modest additional training and planning, but if a decision was made to abolish or modify the requirement involved the constraint would be removed. Among these "quick wins" decisions advocated for in this report are the following:

- Issuing multiple entry visas at the airport and point of entry.
- Extending the validity period for work permits.
- Abolishing the requirement to make investors register at local police stations.
- Eliminating GoJ approvals of land sales to companies with foreign participation.
- Enabling importers to secure blanket guarantees from local banks without tying up so much cash.
- Concluding negotiations and work related to entering into a double taxation treaty with the United States, the European Union, and European Free Trade Agreement (EFTA) states.
- Concluding negotiations and work related to entering into an Encouragement and Protection of Investment Treaty with the EU and EFTA states.

Annex 5 Executive Summary from 2004 Tax Incentives Report

EXECUTIVE SUMMARY[62]

The primary objective of this consultancy is to assist the Minister of Industry and Trade in formulating a new program of investment incentives, based on international best practice, to be used as the basis for regulations to support Interim Law No. (68) for the Year 2003: The Investment Law (hereafter The Interim Law). We do not have a mandate to propose changes in the current tax structure under which the existing investment incentive program was formulated and is to be reformulated. But this consultancy is of the opinion that reformulating the investment incentives under The Interim Law should be undertaken as an integral part of the comprehensive tax reform program envisaged in *Jordan Vision 2020.* The latter requires that "efficiency, fairness, transparency, and even-handed application should be hallmarks of Jordan's tax system."

Jordan's current investment incentive program is too complicated and it is also inefficient. It has been formulated on a highly selective basis in terms of sectors, regions, conditional exemption bases, and the length of period required to qualify for tax incentives. There are several major problems with the program. First, the incentive income tax reductions for selective sectors categorized by development zones significantly worsen the tax distortion arising from the existing multileveled income tax rates, not to mention that the tax holidays are not necessarily effective in attracting large-scale long-term capital investment. Second, the conditions required to obtain import duty exemption for fixed assets are too restrictive and obsolete. Third, the narrowly defined sectoral coverage of the incentive program creates an environment that encourages interest groups to seek even more selective incentives, so that government has to increase taxation on the economy as a whole to meet revenue targets. Fourth, all the incentives require bureaucratic pre-approval. This administrative discretion is undesirable and has been shown elsewhere to encourage corruption. As a result, the long history of investment incentives in Jordan has not proved to be significant in attracting capital investment in directions favored by the government but has simply eroded the base for tax revenue.

To quantify the distorting impact of the existing investment incentive program, we use marginal effective tax rate analysis. The marginal effective tax rate (METR) measures the overall cumulative tax burden incurred by a *marginal* or new investment project under a given tax regime including tax incentives. Our analysis shows that, the current investment incentive program causes an inter-sectoral tax distortion more than double that which would obtain under the current tax structure in the absence of any investment incentives. The inter-sectoral tax distortion is measured by the dispersion of marginal effective tax rates across all business sectors covered in our study. Of course, without any investment incentives, the overall capital cost of investment will be higher owing to the loss in the tax benefit that is available to selective sectors under the current incentive program. However, by providing alternative incentives that are directly linked to capital investment (such as an import
duty exemption and a 20% initial allowance for investment in machinery and equipment) and available to all sectors, not only can the inter-sectoral tax distortion be drastically reduced (from the current 5.5% to 1.8%) but also the *overall* tax cost to business can be

[62] Chen, D, *Reformulating the Tax Incentive Program in Jordan: Analysis and Recommendations, Draft Report* 2004 pp3-6

reduced to a level (13.5%) much lower than that associated with the current investment incentive program (15.1%).

A companion analysis shows that in a cross-country comparison between Jordan and its major competitor countries for foreign investment including Egypt, Israel, Tunisia and Dubai (UAE), Jordan's tax cost to foreign investors as measured by marginal effective tax rates, is the second lowest in manufacturing industry (when measured by Zone A incentives) and the third highest in the services sector (excluding hotels and hospitals). Moreover, Jordan appears to have a wide gap in METR on foreign capital investment between the service and manufacturing sectors (18 percentage points), which is second only to that in Dubai (25 percentage points). This indicates a significant sectoral tax distortion for foreign investors. As a result, considering only the tax cost, foreign investors would have much less interest in Jordan's service sector (including the high-tech service sector) than in its manufacturing industry, which is not beneficial to Jordan's economic modernization. Also note that, when compared with Ireland's tax structure which has a flat rate of 12.5% and no selective tax incentives, Jordan's METR gap between the manufacturing and service sectors (18 percentage points) is 450% times that of Ireland (4 percentage points)! Again, by providing even-handed alternative incentives that are directly linked to capital investment (i.e., an import duty exemption and a 20% initial allowance for investment in machinery and equipment), Jordan would be able to keep its tax advantage in manufacturing industry and become the lowest taxed country in the service sector among its competitor countries; and its sectoral METR gap between manufacturing and services sector would drop to a level close to that of Ireland.

Accordingly, to comply with the principles of efficiency, simplicity and fairness espoused as goals of the tax system in *Jordan Vision 2020* and following international best practice, the currently cumbersome and inefficient investment incentive program in Jordan should be replaced by a simpler and more efficient program that is directly linked to capital investment. Instead of following past thinking and continuing to design discretionary investment incentives, our study suggests adoption of an investment incentive program that is available to all business sectors, in all geographic locations, and at any stage of a business' life. The only condition for qualifying for this investment incentive program is that of investing in Jordan's economy; and no pre-approval should be required. Anticipating a comprehensive tax reform in the near future that will lead to a modernized tax system in Jordan, our recommendations are aimed at eliminating the tax distortion associated with current investment incentives, maintaining Jordan's tax competitiveness in the region, avoiding unnecessary additional administrative and compliance costs, and improving government's capacity to generate tax revenue in the long run.

Recommendation 1: stop granting income tax exemptions and reductions in the current investment incentive program to new investment projects. However, all incentives granted before the implementation of the new program should be "grandfathered" to fulfill past commitments made by the government. But options should be made available to those firms that have been granted incentives under the

current incentive program: they can either choose to continue receiving these incentives until their expiry date or opt for the new incentives provided under recommendations 2-4 below.

Recommendation 2: expand the selective sectoral coverage of the current import duty exemption for fixed capital assets to include all business sectors in Jordan.

This recommendation will affect capital inputs, mainly machinery and equipment (M&E) including spare parts and additional M&E items imported by all investors for business use. This exemption should be implemented along with the general reduction in import duty initiated in 1997 when the Law for Unifying Fees and Taxes Levied upon Imported Goods and Re-exported Goods was introduced. Furthermore, as recommended in Jordan Vision 2020, the "responsibility for qualifying and monitoring the customs and tariff waivers granted to investors" should be transferred "from the Investment Promotion Corporation to the Customs Department, where it more properly belongs." This recommendation is aimed not only at reducing and ultimately eliminating import duty and other indirect taxes on capital goods but also modernizing administrative procedures at Customs. A guideline on how to identify capital goods imported for business purposes should be provided by the Ministry of Industry and Trade.

Recommendation 3: providing a 20% investment allowance for capital invested in machinery and equipment for business use.

The proposed initial investment allowance would be provided during the year when capital is invested. Such an investment allowance would be provided in addition to the annual depreciation allowance-- although the cost of capital for annual depreciation would be reduced by the investment allowance. Any unclaimed investment allowance during the investment year may be carried forward indefinitely to future years.

This investment allowance for machinery and equipment, if adopted, should be provided for all investors in all economic sectors with no conditions whatsoever. Administration of this provision should be the responsibility of the Income Tax Department and hence would be effected in the processing of annual tax returns, with no pre-approval required.

Recommendation 4: providing an expense election for a limited amount of capital investment on an annual basis to support the growth of small and medium entrepreneurs.

Small- and median-sized enterprises (SMEs), usually have very limited access to funding for capital investment, and the size of their annual capital investment likewise tends to be small. But the growth of SMEs is considered critical to more rapid economic growth in the economy as a whole. Under a provision allowing an expense election for capital investment, SMEs could choose to write off their annual capital investment immediately up to a maximum amount rather than use the conventional depreciation allowance. Any unclaimed balance of this maximum amount arising from inadequate operating profits may be converted to the cost of capital for claiming

annual depreciation allowance in the future. This incentive will provide SMEs with a cushion of cash flow during their start-up years, which may be vital to their survival.

Again, this incentive for SME's, if adopted, should be handled by the Income Tax Department administering and filing annual tax returns with no pre-approval required. On the side of regulation, a guideline should be provided jointly by the Ministry of Industry and Trade and the Ministry of Finance on how to identify an SME and what

maximum amount of capital investment should be allowed to be expensed under this provision.

We conducted a revenue simulation for the above recommendations, based on data for 2001. An annual growth rate of 4.5 percent, which was the average for 1998-2003, was also used in generating our revenue estimate for a five-year term. Our revenue simulation shows that the net revenue impact during the base year when all the proposed changes are adopted will be positive but small: revenues would increase by roughly half a million JD. However, as capital investment grows in response to the new incentives that become available for all sectors of the economy, the collection of company income tax can be expected to grow steadily on an annual basis. Note also that, as capital investment and the overall economy grows, revenue from the general sales tax will also grow. To estimate the latter impact, however, requires more sophisticated data (e.g. input-output accounts) and an econometric model (e.g. a quantitative general equilibrium model), neither of which is available at present.

In summary, restructuring the current cumbersome investment incentive package should be seen as the very first step towards creating a more desirable tax environment for capital investment in Jordan. The complexity and inefficiency of the current tax system in Jordan is not unusual in the region, but Jordan can take the lead in reforming its tax system and will benefit accordingly. Of course, tax reform is an ambitious undertaking and requires far more than has been suggested here. In particular, it requires a comprehensive review of both tax structure and tax administration. The observations of this consultancy are that the following should be major issues for future study in such a comprehensive review: reducing the number of company income tax rates from the current three rates to a single rate; providing tax allowances for operating expenses following international norms so as to improve the business environment and promote efficiency; integrating taxation on business income and personal income to prevent excessive tax manipulation; establishing a fair, functional, and market based property tax that is adequate for financing government services related to property values; modernizing income tax administration; and improving sales tax administration to make the sales tax a true consumption tax and prevent the erosion of this tax base.

Annex 6 Jordan's Double Taxation Agreements

I Current comprehensive double taxation agreements that are in force:

	Country	Date of entry into force
1	Egypt	1997
2	Yemen	2000
3	Tunisia	1984
4	Kuwait	2002
5	Bahrain	2002
6	Algeria	2001
7	Arab Economic Council	2000
8	Syria	2002
9	France	1984
10	Romania	1984
11	Turkey	1987
12	Poland	1999
13	India	2000
14	Indonesia	1998
15	Malaysia	2000
16	Canada	2001
17	United Kingdom	2002

II Comprehensive double taxation agreements that have been signed but are not yet in force:

1 Pakistan
2 Italy
3 The Netherlands
4 Czech Republic
5 South Korea
6 Lebanon
7 Qatar
8 Iran
9 Bulgaria
10 Sudan
11 Malta
12 Serbia and Montenegro

III Comprehensive double taxation agreements that have been partially negotiated (first round of negotiations completed):

1 Moldova
2 Ukraine
3 Belarus
4 Croatia
5 Libya
6 Saudi Arabia

IV Countries with which Jordan has exchange double taxation agreement proposals:

1 Russian Federation
2 The United Arab Emirates
3 The United States
4 Dominican Republic
5 South Africa
6 Cyprus
7 Macedonia
8 Greece
9 China
10 Georgia
11 Morocco
12 Armenia
13 Switzerland
14 Thailand
15 Australia
16 Kazakhstan
17 Hungary
18 Uzbekistan

Source: Jordan's Income Tax Department, 5 July 2004

Annex 7 US Double Tax Treaty Policy

Most recent US Treasury testimony at treaty ratification hearings

DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS

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February 25, 2004 (202) 622-2014

TESTIMONY OF
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BEFORE THE SENATE COMMITTEE ON FOREIGN RELATIONS
ON PENDING INCOME TAX AGREEMENTS
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Mr. Chairman and distinguished Members of the Committee, I appreciate the opportunity to appear today at this hearing to recommend, on behalf of the Administration, favorable action on two income tax treaties that are pending before this Committee. We appreciate the Committee's interest in these agreements as demonstrated by the scheduling of this hearing.

This Administration is dedicated to eliminating unnecessary barriers to cross-border trade and investment. The primary means for eliminating tax barriers to trade and investment are bilateral tax treaties. Tax treaties eliminate barriers by providing greater certainty to taxpayers regarding their potential liability to tax in the foreign jurisdiction; by allocating taxing rights between the two jurisdictions so that the taxpayer is not subject to double taxation; by reducing the risk of excessive taxation that may arise because of high gross-basis withholding taxes; and by ensuring that taxpayers will not be subject to discriminatory taxation in the foreign jurisdiction. The international network of over 2000 bilateral tax treaties has established a stable framework that allows international trade and investment to flourish. The success of this framework is evidenced by the fact that countless cross-border transactions, from investments in a few shares of a foreign company by an individual to multi-billion dollar purchases of operating companies in a foreign country, take place each year, with only a relatively few disputes regarding the allocation of tax revenues between governments.

The Administration believes that these agreements with Japan and Sri Lanka would provide significant benefits to the United States and to our treaty partners, as well as our respective business communities. The tax treaty with Japan is a critically important modernization of the economic relationship between the world's two largest economies. The agreement with Sri Lanka represents the first tax treaty between our two countries, and reflects our continuing commitment to extending our treaty network to emerging economies. We urge the Committee and the Senate to take prompt and favorable action on both agreements.

[63] Available at <http://www.ustreas.gov/press/releases/js1191.htm> or <http://foreign.senate.gov/testimony/2004/AngusTestimony040225.pdf>.

Purposes and Benefits of Tax Treaties

Tax treaties provide benefits to both taxpayers and governments by setting out clear ground rules that will govern tax matters relating to trade and investment between the two countries. A tax treaty is intended to mesh the tax systems of the two countries in such a way that there is little potential for dispute regarding the amount of tax that should be paid to each country. The goal is to ensure that taxpayers do not end up caught in the middle between two governments, each of which claims taxing jurisdiction over the same income. A treaty with clear rules addressing the most likely areas of disagreement minimizes the time the two governments (and taxpayers) spend in resolving individual disputes.

One of the primary functions of tax treaties is to provide certainty to taxpayers regarding the threshold question with respect to international taxation: whether the taxpayer's cross-border activities will subject it to taxation by two or more countries. Treaties answer this question by establishing the minimum level of economic activity that must be engaged in within a country by a resident of the other country before the first country may tax any resulting business profits. In general terms, tax treaties provide that if the branch operations in a foreign country have sufficient substance and continuity, the country where those activities occur will have primary (but not exclusive) jurisdiction to tax. In other cases, where the operations in the foreign country are relatively minor, the home country retains the sole jurisdiction to tax its residents. In the absence of a tax treaty, a U.S. company operating a branch or division or providing services in another country might be subject to income tax in both the United States and the other country on the income generated by such operations. Although the United States generally provides a credit against U.S. tax liability for foreign taxes paid, there remains potential for resulting double taxation that could make an otherwise attractive investment opportunity unprofitable, depriving both countries of the benefits of increased cross-border investment.

Tax treaties protect taxpayers from potential double taxation through the allocation of taxing rights between the two countries. This allocation takes several forms. First, the treaty has a mechanism for resolving the issue of residence in the case of a taxpayer that otherwise would be considered to be a resident of both countries. Second, with respect to each category of income, the treaty assigns the "primary" right to tax to one country, usually (but not always) the country in which the income arises (the "source" country), and the "residual" right to tax to the other country, usually (but not always) the country of residence of the taxpayer. Third, the treaty provides rules for determining which country will be treated as the source country for each category of income. Finally, the treaty provides rules limiting the amount of tax that the source country can impose on each category of income and establishes the obligation of the residence country to eliminate double taxation that otherwise would arise from the exercise of concurrent taxing jurisdiction by the two countries.

As a complement to these substantive rules regarding allocation of taxing rights, tax treaties provide a mechanism for dealing with disputes or questions of application that arise after the treaty enters into force. In such cases, designated tax authorities of the two governments – known as the "competent authorities" in tax treaty parlance – are to consult and reach an agreement under which the taxpayer's income is allocated between the two taxing jurisdictions on a consistent basis, thereby preventing the double taxation

that might otherwise result. The U.S. competent authority under our tax treaties is the Secretary of the Treasury. That function has been delegated to the Director, International (LMSB) of the Internal Revenue Service.

In addition to reducing potential double taxation, treaties also reduce "excessive" taxation by reducing withholding taxes that are imposed at source. Under U.S. domestic law, payments to non-U.S. persons of dividends and royalties as well as certain payments of interest are subject to withholding tax equal to 30 percent of the gross amount paid. Most of our trading partners impose similar levels of withholding tax on these types of income. This tax is imposed on a gross, rather than net, amount. Because the withholding tax does not take into account expenses incurred in generating the income, the taxpayer frequently will be subject to an effective rate of tax that is significantly higher than the tax rate that would be applicable to net income in either the source or residence country. The taxpayer may be viewed, therefore, as having suffered "excessive" taxation. Tax treaties alleviate this burden by setting maximum levels for the withholding tax that the treaty partners may impose on these types of income or by providing for exclusive residence-country taxation of such income through the elimination of source-country withholding tax. Because of the excessive taxation that withholding taxes can represent, the United States seeks to include in tax treaties provisions that substantially reduce or eliminate source-country withholding taxes.

Our tax treaties also include provisions intended to ensure that cross-border investors do not suffer discrimination in the application of the tax laws of the other country. This is similar to a basic investor protection provided in other types of agreements, but the non-discrimination provisions of tax treaties are specifically tailored to tax matters and therefore are the most effective means of addressing potential discrimination in the tax context. The relevant tax treaty provisions provide guidance about what "national treatment" means in the tax context by explicitly prohibiting types of discriminatory measures that once were common in some tax systems. At the same time, tax treaties clarify the manner in which possible discrimination is to be tested in the tax context. Particular rules are needed here, for example, to reflect the fact that foreign persons that are subject to tax in the host country only on certain income may not be in the same position as domestic taxpayers that may be subject to tax in such country on all their income.

Tax treaties also include provisions dealing with more specialized situations, such as rules coordinating the pension rules of the tax systems of the two countries or addressing the treatment of employee stock options, Social Security benefits, and alimony and child support in the cross-border context. These provisions are becoming increasingly important as the number of individuals who move between countries or otherwise are engaged in cross-border activities increases. While these subjects may not involve substantial tax revenue from the perspective of the two governments, rules providing clear and appropriate treatment can be very important to each of the individual taxpayers who are affected.

In addition, tax treaties include provisions related to tax administration. A key element of U.S. tax treaties is the provision addressing the exchange of information between the tax authorities. Under tax treaties, the competent authority of one country may request from the other competent authority such information as may be necessary for the proper administration of the country's tax laws; the requested information will be provided

subject to strict protections on the confidentiality of taxpayer information. Because access to information from other countries is critically important to the full and fair enforcement of the U.S. tax laws, information exchange is a priority for the United States in its tax treaty program. If a country has bank secrecy rules that would operate to prevent or seriously inhibit the appropriate exchange of information under a tax treaty, we will not conclude a treaty with that country. In fact, information exchange is a matter we raise with the other country before commencement of formal negotiations because it is one of a very few matters that we consider non-negotiable.

Tax Treaty Negotiating Priorities and Process

The United States has a network of 56 bilateral income tax treaties covering 64 countries. This network includes all 29 of our fellow members of the OECD and covers the vast majority of foreign trade and investment of U.S. businesses. It is, however, appreciably smaller than the tax treaty networks of some other countries. There are a number of reasons for this.

The primary constraint on the size of our tax treaty network may be the complexity of the negotiations themselves. The various functions performed by tax treaties, and particularly the goal of meshing two different tax systems, make the negotiation process exacting and time-consuming.

A country's tax policy, as reflected in its domestic tax legislation as well as its tax treaty positions, reflects the sovereign choices made by that country. Numerous features of the treaty partner's particular tax legislation and its interaction with U.S. domestic tax rules must be considered in negotiating an appropriate treaty. Examples include whether the country eliminates double taxation through an exemption system or a credit system, the country's treatment of partnerships and other transparent entities, and how the country taxes contributions to pension funds, the funds themselves, and distributions from the funds. A treaty negotiation must take into account all of these and many other aspects of the treaty partner's tax system in order to arrive at an agreement that accomplishes the United States' tax treaty objectives.

In any tax treaty negotiation, the two countries may come to the table with very different views of what a final treaty should provide. Each country will have its own list of positions that it considers non-negotiable. The United States, which insists on effective anti-treaty-shopping and exchange of information provisions, and which must accommodate the uniquely complex U.S. tax laws, probably has more non-negotiable positions than most countries. For example, the United States insists on inclusion of a special provision – the "saving clause" – which permits the United States to tax its citizens and residents as if the treaty had not come into effect, as well as special provisions that allow the United States to apply domestic tax rules covering former citizens and long-term residents. Other U.S. tax law provisions that can complicate negotiations include the branch profits tax and the branch level interest tax, rules regarding our specialized investment vehicles, such as real estate mortgage investment conduits, real estate investment trusts and regulated investment companies, and the Foreign Investors in Real Property Tax Act rules. As our international tax rules become more and more complicated, the number of special tax treaty rules that are required increases as well.

Obtaining the agreement of our treaty partners on provisions of importance to the United States sometimes requires other concessions on our part. Similarly, other countries sometimes must make concessions to obtain our agreement on matters that are critical to them. In most cases, the process of give-and-take produces a document that is the best tax treaty that is possible with that other country. In other cases, we may reach a point where it is clear that it will not be possible to reach an acceptable agreement. In those cases, we simply stop negotiating with the understanding that negotiations might restart if circumstances change. Each treaty that we present to the Senate represents not only the best deal that we believe we can achieve with the particular country, but also constitutes an agreement that we believe is in the best interests of the United States.

In establishing our negotiating priorities, our primary objective is the conclusion of tax treaties or protocols that will provide the greatest economic benefit to the United States and to U.S. taxpayers. We communicate regularly with the U.S. business community, seeking input regarding the areas in which treaty network expansion and improvement efforts should be focused and information regarding practical problems encountered by U.S. businesses with respect to the application of particular treaties and the application of the tax regimes of particular countries.

The U.S. commitment to including comprehensive provisions designed to prevent "treaty shopping" in all of our tax treaties is one of the keys to improving our overall treaty network. Our tax treaties are intended to provide benefits to residents of the United States and residents of the particular treaty partner on a reciprocal basis. The reductions in source-country taxes agreed to in a particular treaty mean that U.S. persons pay less tax to that country on income from their investments there and residents of that country pay less U.S. tax on income from their investments in the United States. Those reductions and benefits are not intended to flow to residents of a third country. If third-country residents can exploit one of our treaties to secure reductions in U.S. tax, the benefits would flow only in one direction. Such use of treaties is not consistent with the balance of the deal negotiated. Moreover, preventing this exploitation of our treaties is critical to ensuring that the third country will sit down at the table with us to negotiate on a reciprocal basis, so that we can secure for U.S. persons the benefits of reductions in source-country tax on their investments in that country.

Despite the protections provided by the limitation on benefits provisions, there may be countries with which a tax treaty is not appropriate because of the possibility of abuse. With other countries there simply may not be the type of cross-border tax issues that are best resolved by treaty. For example, we generally do not conclude tax treaties with jurisdictions that do not impose significant income taxes, because there is little possibility of the double taxation of income in the cross-border context that tax treaties are designed to address; with such jurisdictions, an agreement focused on the exchange of tax information can be very valuable in furthering the goal of reducing U.S. tax evasion.

The situation is more complex when a country adopts a special preferential regime for certain parts of the economy that is different from the rules generally applicable to the country’s residents. In those cases, the residents benefiting from the preferential regime do not face potential double taxation and so should not be entitled to the reductions in U.S. withholding taxes accorded by a tax treaty, while a treaty relationship might be useful and appropriate in order to avoid double taxation in the case of the residents who do not receive the benefit of the preferential regime. Accordingly, in some cases we have

tax treaty relationships that carve out certain categories of residents and activities from the benefits of the treaty. In other cases, we have determined that economic relations with the relevant country were such that the potential gains from a tax treaty were not sufficient to outweigh the risk of abuse, and have therefore decided against entering into a tax treaty relationship (or have terminated an existing relationship).

Prospective treaty partners must evidence a clear understanding of what their obligations would be under the treaty, including those with respect to information exchange, and must demonstrate that they would be able to fulfill those obligations. Sometimes a potential treaty partner is unable to do so. In other cases we may feel that a tax treaty is inappropriate because the potential treaty partner is not willing to agree to particular treaty provisions that are needed in order to address real tax problems that have been identified by U.S. businesses operating there.

Lesser developed and newly emerging economies, for which capital and trade flows with the United States are often disproportionate or virtually one way, may be reluctant to agree to the reductions in source-country withholding taxes preferred by the United States because of concerns about the short-term effects on their tax revenues. These countries have two somewhat conflicting objectives. They need to reduce barriers to investment, which is the engine of development and growth, and reducing source-country withholding taxes reduces a significant barrier to inward investment. On the other hand, reductions in source-country withholding taxes may reduce tax revenues in the short-term. Because this necessarily involves the other country's judgment regarding the level of withholding taxes that will best balance these two objectives, our tax treaties with developing countries often provide for higher maximum rates of source-country tax than is the U.S. preferred position. Such a treaty nevertheless provides benefits to taxpayers by establishing a stable framework for taxation. Moreover, having an agreement in place makes it easier to agree to further reductions in source-country withholding taxes in the future. It is important to recognize that even where the current capital and trade flows between two treaty countries are disproportionate, conclusion of a tax treaty is not a zero-sum exercise. The goal of the tax treaty is to increase the amount and efficiency of economic activity, so that the situation of each party is improved.

For a country like the United States that has significant amounts of both inbound and outbound investment, treaty reductions in source-country withholding taxes do not have the same one-directional impact on tax revenues, even looking just at the short-term effects. Reductions in withholding tax imposed by the source country on payments made to foreign investors represent a short-term static reduction in source-country tax revenues. However, reductions in foreign withholding taxes borne by residents on payments received with respect to foreign investments represent an increase in tax revenues because of the corresponding reduction in the foreign tax credits that otherwise would offset the residents' domestic tax liabilities. Thus, the reciprocal reductions in source-country withholding taxes accomplished by treaty will have offsetting effects on tax revenues even in the short term.

More importantly, looking beyond any net short-term effect on tax liabilities, an income tax treaty is a negotiated agreement under which both countries expect to be better off in the long run. These long-term economic benefits far outweigh any net short-term static effects on tax liabilities. Securing the reduction or elimination of foreign withholding taxes imposed on U.S. investors abroad can reduce their costs and improve their

competitiveness in connection with international business opportunities. Reduction or elimination of the U.S. withholding tax imposed on foreign investors in the United States may encourage inbound investment, and increased investment in the United States translates to more jobs, greater productivity and higher wage rates. The tax treaty as a whole creates greater certainty and provides a more stable environment for foreign investment. The agreed allocation of taxing rights between the two countries reduces cross-border impediments to the bilateral flow of capital, thereby allowing companies and individuals to more effectively locate their operations in such a way that their investments are as productive as possible. This increased productivity will benefit both countries' economies. The administrative provisions of the tax treaty provide for cooperation between the two countries, which will help reduce the costs of tax administration and improve tax compliance.

Discussion of Proposed New Treaties and Protocols

I now would like to discuss the two agreements that have been transmitted for the Senate's consideration. We have submitted Technical Explanations of each agreement that contain detailed discussions of the provisions of each treaty and protocol. These Technical Explanations serve as an official guide to each agreement.

Japan

The proposed Convention and Protocol with Japan was signed in Washington on November 6, 2003. The Convention and Protocol are accompanied by an exchange of diplomatic notes, also dated November 6, 2003. The Convention, Protocol and notes replace the existing U.S.-Japan tax treaty, which was signed in 1971.

Because the existing treaty dates back to 1971, it does not reflect the changes in economic relations between the two countries that have taken place over the last thirty years. Today, the trade and investment relationship between the United States and Japan, the world's two largest economies, is critical to creating economic growth throughout the world. The proposed new treaty significantly reduces existing tax-related barriers to trade and investment between Japan and the United States. Reducing these barriers will help to foster still-closer economic ties between the two countries, enhancing the competitiveness of both countries' businesses and creating new opportunities for trade and investment.

The existing treaty also is inconsistent in many respects with U.S. tax treaty policy. The proposed new treaty brings the treaty relationship into much closer conformity with U.S. policy and generally modernizes the agreement in a manner consistent with other recent treaties. At the same time, several key provisions of the new treaty represent "firsts" for Japan. The evolution embodied in this agreement may very well provide important precedents for many countries in the region that look to Japan for guidance and leadership in this regard.

Perhaps the most dramatic advances in the proposed new treaty are reflected in the reciprocal reductions in source-country withholding taxes on income from cross-border investments. The existing treaty sets maximum rates for withholding taxes on cross-border interest, royalty and dividend payments that are much higher than the rates reflected in the U.S. model tax treaty and provided in most U.S. tax treaties with developed countries. The new treaty substantially lowers these maximum withholding tax

rates, bringing the limits in line with U.S. preferred tax treaty provisions. The maximum rates of source-country withholding tax provided in the new treaty are as low as, and in many cases significantly lower than, the rates provided for in any other tax treaty entered into by Japan. These important reductions in source-country withholding tax agreed in this new treaty reflect the commitment of both governments to facilitating cross-border investment.

In today's knowledge-driven economy, intangible property developed in the United States, such as trademarks, industrial processes or know-how, is used around the world. Given the importance of the cross-border use of intangibles between the United States and Japan, a primary objective from the U.S. perspective in negotiating a new tax treaty with Japan was to overhaul the existing rules for the treatment of cross-border income from intangible property. This goal is achieved in the proposed new treaty through the complete elimination of source-country withholding taxes on royalties. This is the first treaty in which Japan has agreed to eliminate source-country withholding taxes on royalties.

The proposed new treaty is a major change from the existing treaty, which allows the source country to impose a 10 percent withholding tax on cross-border royalties. The gross-basis taxation provided for under the existing treaty is particularly likely to lead to excessive taxation in the case of royalties because the developer of the licensed intangible who receives the royalty payments typically incurs substantial expenses, through research and development or marketing. The existing treaty's 10-percent withholding tax imposed on gross royalties can represent a very high effective rate of source-country tax on net income when the expenses associated with such income are considered. In addition, because withholding taxes can be imposed on cross-border payments where the taxpayer has no presence in the source country, the existing treaty's allowance of such taxes on royalties created a significant disparity in treatment between royalty income and services and other income. This has been particularly problematic as the line between the types of income is not always clear.

With the elimination of source-country royalty withholding taxes provided for in the proposed new treaty, royalties will be taxed exclusively by the country of residence on a net basis in the same manner as other business profits. This eliminates the excessive taxation that can occur under the existing treaty. Moreover, treating royalties in the same manner as business profits removes the disparity in treatment between royalty income and services and other income and therefore eliminates what has been a significant source of dispute and potential double taxation for U.S. taxpayers under the existing treaty. As a final note, this change in the U.S.-Japan treaty relationship may well have positive effects for other U.S. treaty negotiations. Japan's historic policy of retaining its right to impose withholding tax on royalties in its tax treaties has encouraged other countries to do the same. The change in this policy reflected in the new treaty may serve as an impetus to other countries to consider agreeing by treaty to greater reductions in source-country withholding taxes on royalties.

The proposed new treaty also reflects significant improvements in the rules regarding cross-border interest payments. The existing treaty provides for a maximum withholding tax rate of 10 percent for all interest payments other than a narrow class of interest paid to certain government entities. The new treaty includes provisions eliminating source-country withholding taxes for significant categories of interest. The most important of

these is the elimination of source-country withholding tax for interest earned by financial institutions. Due to the highly-leveraged nature of financial institutions, imposition of a withholding tax on interest received by such enterprises could result in taxation that actually exceeds the net income from the transaction. The new treaty will eliminate this potential for excessive taxation, with cross-border interest earned by financial institutions taxed exclusively by the residence country on a net basis. The new treaty also provides for the elimination of source-country withholding taxes in the case of interest received by the two governments, interest received in connection with sales on credit, and interest earned by pension funds. This elimination of source-country withholding taxes on income earned by tax-exempt pension funds ensures that the assets expected to accumulate tax-free to fund retirement benefits are not reduced by foreign taxes; a withholding tax in this situation would be particularly burdensome because there is no practical mechanism for providing individual pension beneficiaries with a foreign tax credit for withholding taxes that were imposed on investment income years before the retiree receives pension distributions. These exemptions from source-country withholding tax for interest provided in the new treaty are broader than in any other Japanese tax treaty.

In addition, the proposed new treaty significantly reduces source-country withholding taxes with respect to all types of cross-border dividends. Under the existing treaty, direct investment dividends (that is, dividends paid to companies that own at least 10 percent of the stock of the paying company) generally may be taxed by the source country at a maximum rate of 10 percent and portfolio dividends may be taxed at a maximum rate of 15 percent. The new treaty reduces the maximum rates of source-country withholding tax to 5 percent for direct investment dividends and 10 percent for portfolio dividends. The new treaty also provides for the elimination of source-country withholding taxes on certain intercompany dividends where the dividend is received by a company that owns more than fifty percent of the voting stock of the company paying the dividend. This provision is similar to provisions included in the U.S. treaties with the United Kingdom, Australia, and Mexico. The elimination of withholding taxes on this category of intercompany dividends is substantially narrower than provisions in other Japanese treaties. In addition, the new treaty includes a provision that eliminates source-country withholding taxes on dividends paid to pension funds, which parallels the treatment of interest paid to pension funds.

Treasury believes that this provision eliminating source-country withholding taxes on certain intercompany dividends is appropriate in light of our overall treaty policy of reducing tax barriers to cross-border investment and in the context of this important treaty relationship. As I have testified previously, the elimination of source-country taxation of dividends is something that is to be considered only on a case-by-case basis. It is not the U.S. model position because we do not believe that it is appropriate to agree to such an exemption in every treaty. Consideration of such a provision in a treaty is appropriate only if the treaty contains anti-treaty-shopping rules that meet the highest standards and the information exchange provision of the treaty is sufficient to allow us to confirm that the requirements for entitlement to this benefit are satisfied. Strict protections against treaty shopping are particularly important when the elimination of withholding taxes on intercompany dividends is included in relatively few U.S. treaties. In addition to these prerequisites, the overall balance of the treaty must be considered.

These conditions and considerations all are met in the case of the proposed new treaty with Japan. The new treaty includes the comprehensive anti-treaty-shopping provisions

sought by the United States, provisions that are not contained in the existing treaty. The new treaty includes exchange of information provisions comparable to those in the U.S. model treaty. In this regard, Japan recently enacted domestic legislation to ensure that it can obtain and exchange information pursuant to a tax treaty even in cases where it does not need the particular information for its own tax purposes.

The United States and U.S. taxpayers benefit significantly both from this provision in the new agreement and from the treaty overall. The elimination of source-country withholding taxes on intercompany dividends provides reciprocal benefits because Japan and the United States both have dividend withholding taxes and there are substantial dividend flows going in both directions. U.S. companies that are in an excess foreign tax credit position will be able to keep every extra dollar they receive if the dividends they repatriate to the United States are free of Japanese withholding tax. The treaty as a whole reflects dramatic reductions in source-country withholding taxes relative to the existing treaty. The elimination of withholding taxes on royalties and certain interest was a key objective for the United States; while these provisions secured in this new treaty are consistent with U.S. tax treaty policy, they are an unprecedented departure from historic Japanese tax treaty policy.

Another important change reflected in the proposed new treaty is the addition of an article providing for the elimination of source-country withholding taxes on “other income”, which include types of financial services income that under the existing treaty could have been subject to gross-basis tax by the source country. In particular, the Protocol confirms that securities lending fees, guarantee fees, and commitment fees generally will not be subject to source-country withholding tax and rather will be taxable in the same manner as other business profits.

The proposed new treaty provides that the United States generally will not impose the excise tax on insurance policies issued by foreign insurers if the premiums on such policies are derived by a Japanese enterprise. This provision, however, is subject to the anti-abuse rule that denies the exemption if the Japanese insurance company were to enter into reinsurance arrangements with a foreign insurance company that is not itself eligible for such an exemption.

Another significant modernization reflected in the proposed new treaty is the inclusion of specific rules regarding the application of treaty provisions in the case of investments in one country made by residents of the other country through partnerships and other flow-through entities. These rules coordinate the domestic law rules of Japan and the United States in this area in order to provide for certainty in results for cross-border businesses operated in partnership form.

In the case of shipping income, the proposed new treaty provides for exclusive residence-country taxation of profits from the operation in international traffic of ships or aircraft. This elimination of source-country tax covers profits from the rental of ships and aircraft on a full basis; it also covers profits from rentals on a bareboat basis if the rental income is incidental to profits from the operation of ships or aircraft in international traffic. In addition, the new treaty provides an exemption from source-country tax for all income from the use, maintenance or rental of containers used in international traffic.

The proposed new treaty generally provides for exclusive residence-country taxation of gains with narrow exceptions, which is generally consistent with U.S. tax treaty preferences but is a departure from the source-country taxation of gains that is provided for in recent Japanese treaties. The new treaty provides for source-country taxation of share gains in two circumstances. First, the new treaty includes a rule similar to that in U.S. domestic law under which gains from the sale of shares or other interests in an entity investing in real estate may be taxed by the country in which the real estate is located. Second, it contains a narrow rule dealing with gains on stock in restructured financial institutions that was included at the request of Japan. Under this rule, the source country may tax gains on stock of a financial institution if the financial institution had received substantial financial assistance from the government under rules relating to distressed financial institutions, the stock was purchased from the government, and the stock is sold within five years of such assistance. Under a very broad grandfather rule, this provision does not apply to any stock held by an investor who made an investment in such a financial institution prior to the entry into force of the new treaty including any additional stock in the financial institution that the investor acquires subsequently.

Like the existing treaty, the proposed new treaty provides that pensions and social security benefits may be taxed only by the residence country. The new treaty also provides rules regarding the allocation of taxing rights with respect to compensation earned in the form of employee stock options.

The proposed new treaty provides rules governing income earned by entertainers and sportsmen, corporate directors, government employees, and students that are consistent with the rules of the U.S. model treaty. The new treaty continues and improves a host-country exemption for income earned by teachers that is found in the existing treaty, although not in the U.S. model.

The proposed new treaty contains a comprehensive limitation on benefits article, which provides detailed rules designed to deny “treaty shoppers” the benefits of the treaty. These rules, which were not contained in the existing treaty and which have not been included in this form in other Japanese tax treaties, are comparable to the rules contained in recent U.S. treaties.

At the request of Japan, the proposed new treaty includes an additional limit on the availability of treaty benefits obtained in connection with certain back-to-back transactions involving dividends, interest, royalties or other income. This provision is substantially narrower than the “conduit arrangement” language found in the 2003 treaty with the United Kingdom. It is intended to address abusive transactions involving income that flows to a third-country resident. Japanese domestic law does not provide sufficient protection against these abusive transactions. The stricter protections against this type of abuse that are provided under U.S. domestic law will continue to apply.

The proposed new treaty provides relief from double taxation in a manner consistent with the U.S. model. The new treaty also includes a re-sourcing rule to ensure that a U.S. resident can obtain a U.S. foreign tax credit for Japanese taxes paid when the treaty assigns to Japan primary taxing rights over an item of gross income. A comparable rule applies for purposes of the Japanese foreign tax credit.

The proposed new treaty provides for non-discriminatory treatment (i.e., national treatment) by one country to residents and nationals of the other. Also included in the new treaty are rules necessary for administering the treaty, including rules for the resolution of disputes under the treaty. The information exchange provisions of the new treaty generally follow the U.S. model and make clear that Japan will provide U.S. tax officials such information as is relevant to carry out the provisions of the treaty and the domestic tax laws of the United States. Inclusion of this U.S. model provision was made possible by a recent change in Japanese law.

Sri Lanka

The United States does not currently have an income tax treaty with Sri Lanka. The proposed income tax Convention with Sri Lanka was signed in Colombo on March 14, 1985 but was not acted on by the Senate at that time because changes made to U.S. international tax rules by the Tax Reform Act of 1986 necessitated some modifications to the agreement. The proposed Protocol, which was signed on September 20, 2002, amends the 1985 Convention to reflect changes in domestic law since 1985 as well as developments in U.S. tax treaty policy and includes modifications that better reflect U.S. tax treaty preferences. We are requesting the Committee to report favorably on both the 1985 Convention and the 2002 Protocol.

The proposed new treaty generally follows the pattern of the U.S. model treaty, while incorporating some provisions found in other U.S. treaties with developing countries. The maximum rates of source-country withholding taxes on investment income provided in the proposed treaty are generally equal to or lower than the maximum rates provided in other U.S. treaties with developing countries (and some developed countries).

The proposed treaty generally provides a maximum source-country withholding tax rate on dividends of 15 percent. Special rules consistent with those in the U.S. model treaty apply to certain dividends paid by a U.S. real estate investment trust. The proposed treaty provides a maximum source-country withholding tax rate on interest of 10 percent. This source-country tax is eliminated in the case of interest paid by one of the two governments or received by one of the two governments or one of the central banks.

Under the proposed treaty, royalties may be subject to source-country withholding taxes at a maximum rate of 10 percent. As in many treaties with developing countries, the royalties article also covers rents with respect to tangible personal property; in the case of such rents, however, the maximum withholding tax rate is 5 percent. These rules in the proposed treaty do not apply to rental income with respect to the lease of containers, ships or aircraft, which is instead covered by the specific rules in the shipping article.

The rules in the proposed treaty relating to income from shipping and air transport are complicated in terms of drafting, but produce results that in most cases are consistent with many recent U.S. tax treaties. First and simplest, under the proposed treaty income derived from the rental of containers used in international traffic is taxable only in the country of residence and not in the source country. Exclusive residence-country taxation of such income is the preferred U.S. position reflected in the U.S. model treaty. Second, the proposed treaty provides that income derived from the international operation of aircraft also is taxable only in the country of residence. This rule eliminating source-country tax covers income derived from aircraft leases on a full basis as well as profits

from the rental of aircraft on a bareboat basis if the aircraft are operated in international traffic by the lessee or if the lease is incidental to other profits from the operation of aircraft. Third, the rules in the treaty provide for some source-country taxation of income from the operation and rental of ships, but not to exceed the source-country tax that may be imposed under any of Sri Lanka's other treaties. Sri Lanka has entered into two treaties that eliminate source-country tax on income from the operation of ships and has confirmed through diplomatic note that this exemption from source-country tax will apply in the case of the United States as well.

The proposed treaty provides the basic tax treaty rule that business profits of a resident of one of the treaty countries generally may be taxed in the other country only when such profits are attributable to a permanent establishment located in that other country. The rules in the proposed treaty permit broader host-country taxation than is provided for in the U.S. model treaty. In this regard, the definition of permanent establishment in the proposed treaty is somewhat broader than the definition in the U.S. model, which lowers the threshold level of activity required for imposition of host-country tax. This permanent establishment definition is consistent with other U.S. treaties with developing countries. In addition, the proposed treaty provides that certain profits that are not attributable to the permanent establishment may be taxed in the host state if they arise from business activities carried on in the host state that are similar to those carried on through the permanent establishment. These rules are quite similar to rules found in our tax treaties with other developing countries.

The proposed treaty's rules for taxation of income from personal services similarly are consistent with our recent treaties with developing countries. Under the proposed treaty, income earned through independent personal services may be taxed in the host country if they are performed through a fixed base or if the individual performing the services was in the host country for more than 183 days in any 12-month period. The proposed treaty provides rules governing income earned by entertainers and sportsmen, corporate directors and government employees that are broadly consistent with the rules of the U.S. model treaty. The proposed treaty also includes a limited exemption from source country taxation of students.

The proposed treaty contains a comprehensive limitation on benefits article, which provides detailed rules designed to deny "treaty shoppers" the benefits of the treaty. These rules are comparable to the rules contained in the U.S. model and recent U.S. treaties.

The proposed treaty also sets out the manner in which each country will relieve double taxation. Both the United States and Sri Lanka will provide such relief through the foreign tax credit mechanism, including a deemed paid credit for indirect taxes paid by subsidiary companies.

The proposed treaty provides for non-discriminatory treatment (i.e., national treatment) by one country to residents and nationals of the other. Also included in the proposed treaty are rules necessary for administering the treaty, including rules for the resolution of disputes under the treaty.

The proposed treaty includes an exchange of information provision that generally follows the U.S. model. Under these provisions, Sri Lanka will provide U.S. tax officials such

information as is relevant to carry out the provisions of the treaty and the domestic tax laws of the United States. Sri Lanka has confirmed through diplomatic note its ability to obtain and exchange key information relevant for tax purposes. The information that may be exchanged includes information held by financial institutions, nominees or persons acting in an agency or fiduciary capacity.

Treaty Program Priorities

We continue to maintain a very active calendar of tax treaty negotiations. We currently are in ongoing negotiations with Bangladesh, Canada, Chile, Hungary, Iceland and Korea. We also have substantially completed work with the Netherlands, France and Barbados and look forward to the conclusion of these new agreements.

With respect to future negotiations, we expect to begin discussions soon with Germany and Norway. Another key priority is updating the few remaining treaties that provide for low withholding tax rates but do not include the limitation on benefits provisions needed to protect against the possibility of treaty shopping. Also a priority is entering into new treaties with the former Soviet republics that are still covered by the old U.S.S.R. treaty (which does not include an adequate exchange of information provision). We also are focused on continuing to expand our treaty network by entering into new tax treaty relationships with countries that have the potential to be important trading partners in the future.

Significant resources have been devoted in recent years to the negotiation of new tax treaties with Japan and the United Kingdom, two major trade and investment partners for the United States and two of our oldest tax treaties. With the completion of these important negotiations, we believe that it would be appropriate to update the U.S. model treaty to reflect our negotiating experiences since 1996. A new model will help facilitate the negotiations we expect to begin in the near future. We look forward to working with the staffs of the Senate Foreign Relations Committee and Joint Committee on Taxation on this project.

Conclusion

Let me conclude by again thanking the Committee for its continuing interest in the tax treaty program, and the Members and staff for devoting the time and attention to the review of these new agreements. We appreciate the assistance and cooperation of the staffs of this Committee and of the Joint Committee on Taxation in the tax treaty process.

We urge the Committee to take prompt and favorable action on the agreements before you today. Such action will help to reduce barriers to cross-border trade and investment by further strengthening our economic relations with a country that has been a significant economic and political partner for many years and by expanding our economic relations with an important trading partner in the developing world.

Annex 8 Treatment of Foreign Tax Incentives in DTAs

8.1 Typical Provision in Some US DTAs About 'Tax Sparing'

NOTES OF EXCHANGE[64]
Rabat, *August 1, 1977.*
The Honorable Robert Anderson,
American Ambassador,
Rabat.

Dear Mr. Ambassador: During the discussions which were held in both Rabat and Washington for the purpose of concluding a convention to avoid double taxation between the United States and Morocco, the Moroccan delegation emphasized to the American delegation that the Moroccan Government, for the purpose of promoting private investment, will exempt certain profits and interest payments from taxation. The Moroccan delegation expressed its hope that the U.S. Government would accordingly grant citizens and residents of the United States a "tax-sparing" credit against the U.S. tax. The U.S. delegation indicated that the Senate has been reluctant to approve such a provision in other tax conventions. However, the U.S. delegation has promised to review its position should the Senate reconsider its decision on this matter.

I would be grateful to you if you would confirm your government's commitment to resume discussions on this point should the Senate approve a provision of this kind in the interest of another country.

Please accept, Mr. Ambassador, assurances of my highest esteem.

ABDELKADER BENSLIMANE

8.2 OECD: Tax Sparing: A Reconsideration (1998)[65]

VII. RECOMMENDATIONS

94. This report has identified a number of concerns that put into question the usefulness of the granting of tax sparing relief by OECD Member countries. These concerns relate in particular to
– the potential for abuse offered by tax sparing;
– the effectiveness of tax sparing as an instrument of foreign aid; and
– general concerns with the way in which tax sparing may encourage countries to use tax incentives.

95. The Report has shown that tax sparing is very vulnerable to taxpayer abuse, which can be very costly in terms of lost revenue to both the residence and source country. Experience has shown that this kind of abuse is difficult to detect. In addition, even where

[64] Available at <http://www.unclefed.com/ForTaxProfs/Treaties/morocco.pdf>.
[65] Organisation for Economic Co-operation and Development, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998) 20-21.

it is detected, it is difficult for residence countries to react quickly against such abuse. The process of persuading treaty partners of the necessity to remove or modify existing tax sparing provisions to prevent such abuses may be slow and cumbersome.

96. The emerging change in attitude among countries towards tax sparing has to be seen also in the context of the increasing problem with harmful tax competition. The continued, and in recent years accelerating, integration of national economies has made many segments of the national tax bases increasingly geographically mobile. These developments have induced some countries to adopt tax regimes that have as their primary purpose the erosion of the tax bases of other countries. These types of tax incentives are specifically tailored to target highly mobile financial and other services that are particularly sensitive to tax differentials. The potentially harmful effects of such regimes may be aggravated by the existence of ill-designed tax sparing provisions in treaties. This is particularly so where a country adopts a tax regime subsequent to the conclusion of treaties and tailors this regime so as to ensure that it is covered by the scope of the existing tax sparing provision.

97. This report has also shown that tax sparing is not necessarily an adequate tool to promote economic development. Countries that have traditionally sought to obtain tax sparing benefits in treaties may have good reasons to reconsider their position on the issue. The report not only challenges the assumption generally underlying tax sparing, but it also suggests that tax sparing, by promoting the repatriation of profits, provides an inherent incentive to the foreign investor to engage in short-term investment projects and a disincentive to operate in the source country on a long-term basis.

98. The argument that tax sparing is needed to prevent that the granting of a tax incentive by a host country merely results in a transfer of tax revenues to the country of residence of the investor ignores the fact that this revenue transfer will occur only to the extent that profits are repatriated. No nullification will occur if there is no repatriation. But, even if profits are repatriated, the features of foreign tax credit systems, which all allow some form of pooling of foreign income, may be structured in such a way that tax may not necessarily be levied in the country of residence notwithstanding that no or low tax is imposed in the country of source.

99. The analysis of this report does not suggest that OECD and other countries which have traditionally granted tax sparing should necessarily cease to do so. In bilateral negotiations between Member and non-Member countries, some countries will, for what they see as legitimate reasons, continue to press for such provisions. But the strength of their case will need to be assessed in the course of their negotiation or renegotiation of bilateral treaties. In addition, it may now be an appropriate time to consider how OECD countries working together with non-Member countries can develop a more coherent position towards the granting of tax sparing. This may enable Member countries to reassess the need to give tax sparing, particularly to countries that have reached a certain level of economic development. In judging whether there is a case for continuing to provide tax sparing, countries will need to balance the considerations discussed in the preceding sections, particularly the scope for abuse and the role which tax sparing has played in encouraging tax competition. This would also assist countries that chose to grant tax sparing to achieve a better targeting of the provisions and to reduce the potential for abuse. Non-Member countries that have traditionally requested tax sparing should

reconsider whether this is an appropriate instrument to promote economic development and whether tax sparing serves their long-term economic interests.

100. The Committee on Fiscal Affairs recommends that if a Member country chooses to give tax sparing credits, tax sparing should be considered only in regard to countries the economic level of which is considerably below that of OECD Member countries. Member countries should employ objective economic criteria to define countries eligible for tax sparing. Where countries agree to insert a tax sparing provision, they are encouraged to follow the guidance set out in Section VI of this report. The use of these “best practices” will minimise the potential for abuse of such provisions by ensuring that they apply exclusively to genuine investments aimed at developing the domestic infrastructure of the source country. A narrow provision applying to real investment would also discourage harmful tax competition for geographically mobile activities.

Annex 9 Exchange of Information Required in Select US DTAs

The three main sources for the extracts from US double tax treaties and associated documents are: the US Treasury website at <http://www.ustreas.gov/offices/tax-policy/treaties.shtml>; International Bureau of Fiscal Documentation, *Tax Treaties Database*, accessed on 16 September 2004; and, <http://www.unclefed.com/ForTaxProfs/Treaties>.

9.1 US Model DTA 1996

ARTICLE 26: Exchange of Information and Administrative Assistance[66]

1. The competent authorities of the Contracting States shall exchange such information as is relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention, including information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. The exchange of information is not restricted by Article 1 (General Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:
a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
b) to supply information that is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
c) to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

3. Notwithstanding paragraph 2, the competent authority of the requested State shall have the authority to obtain and provide information held by financial institutions, nominees or persons acting in an agency or fiduciary capacity, or respecting interests in a person, including bearer shares, regardless of any laws or practices of the requested State that might otherwise preclude the obtaining of such information. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain that information in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State, notwithstanding that the other State may not, at that time, need such information for purposes of its own tax. If specifically requested by the competent

[66] Available at <http://www.ustreas.gov/offices/tax-policy/library/model996.pdf> pp40-41.

authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.
4. Each of the Contracting States shall endeavor to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by the Convention from taxation imposed by that other State does not inure to the benefit of persons not entitled thereto.

This paragraph shall not impose upon either of the Contracting States the obligation to carry out administrative measures that would be contrary to its sovereignty, security, or public policy.

5. For the purposes of this Article, the Convention shall apply, notwithstanding the provisions of Article 2 (Taxes Covered), to taxes of every kind imposed by a Contracting State.

6. The competent authority of the requested State shall allow representatives of the applicant State to enter the requested State to interview individuals and examine books and records with the consent of the persons subject to examination.

9.2 US-Morocco Double Tax Treaty 1977 (effective 1 January 1981)

ARTICLE 26: Exchange of Information[67]

(1) The competent authorities of the Contracting States shall exchange such information as is pertinent to carrying out the provisions of this Convention and of the domestic laws of the Contracting States concerning taxes covered by this Convention. Any information so exchanged shall be treated as secret and shall not be disclosed to any persons other than those (including a court or administrative body) concerned with assessment, collection, enforcement, or prosecution in respect of the taxes which are the subject of this Convention.

(2) In no case shall the provisions of paragraph (1) be construed so as to impose on one of the Contracting States the obligation-

(a) To carry out administrative measures at variance with the laws or the administrative practice of that Contracting State or the other Contracting State;

(b) To supply particulars which are not obtainable under the laws, or in the normal course of the administration, of that Contracting State or of the other Contracting State; or

(c) To supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information, the disclosure of which would be contrary to public policy.

[67] Available at <http://www.unclefed.com/ForTaxProfs/Treaties/morocco.pdf>.

(3) The exchange of information shall be either on a routine basis or on request with reference to particular cases. The competent authorities of the Contracting States may agree on the list of information which shall be furnished on a routine basis.
(4) The competent authorities of the Contracting States shall notify each other of any amendments of the tax laws referred to in paragraph (1) of Article 1 (Taxes Covered) and of the adoption of any taxes referred to in paragraph (2) of Article 1 (Taxes Covered) by transmitting the texts of any amendments or new statutes at least once a year.
(5) The competent authorities of the Contracting States shall notify each other of the publication by their respective Contracting States of any material concerning the application of this Convention, whether in the form of regulations, rulings, or judicial decisions by transmitting the texts of any such materials at least once a year.

9.3 US-Egypt Double Tax Treaty 1980 (effective 1 January 1982)

ARTICLE 28: Exchange of Information[68]

(1) The competent authorities shall exchange such information as is necessary for carrying out the provisions of this Convention or for the prevention of fraud or for the administration of statutory provisions concerning taxes to which this Convention applies provided the information is of a class that can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

(2) Any information so exchanged shall be treated as secret, except that such information may be-
(a) Disclosed to any person concerned with, or
(b) Made part of a public record with respect to, the assessment, collection, or enforcement of, or litigation with respect to, the taxes to which this Convention applies.

(3) No information shall be exchanged which would be contrary to public policy.

(4) If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and copies of unedited original documents (including books, papers, statements, records, accounts, or writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of each Contracting State with respect to its own taxes.

(5) Depositions and evidence which may be furnished in accordance with this Article shall not be withheld by reason of any doctrine of law under which international judicial assistance is not accorded in tax matters.

(6) The exchange of information shall be carried out promptly either on a routine basis or on request with reference to particular cases. The competent authorities of the Contracting States may agree on the list of information which shall be furnished on a routine basis.

9.4 US-Tunisia Double Tax Treaty 1985 (effective 1 January 1990)

Article 26 Exchange of information and administrative assistance

[68] Available at <http://www.unclefed.com/ForTaxProfs/Treaties/egypt.pdf>.

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The competent authorities shall also notify each other of official published information concerning the application of the Convention. The exchange of information is not restricted by Article 1 (Personal scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

(a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
(b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
(c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

3. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State.

US TREASURY TECHNICAL EXPLANATION OF ARTICLE 26, US-TUNISIA DTA (1990)

Article 26 Exchange of information

This Article provides that the competent authorities shall exchange information with respect to the taxes enumerated in Article 2 (Taxes covered) for the purpose of applying the Convention or the domestic laws of the Contracting States concerning taxes covered by the Convention, provided that the taxation under the domestic laws is not contrary to the Convention. The information exchanged may relate to nonresidents as well as to residents of a Contracting State. The State receiving information under this Article must keep it secret in the same manner as information obtained under its domestic laws. The information may be made available only to persons involved in the assessment, collection, administration, or enforcement of the taxes covered by the Convention, or in the prosecution or determination of appeals in relation to such taxes; and the information may be used only for such purposes. It may be disclosed in public court proceedings or in judicial decisions. The General Accounting Office and the tax-writing committees of

Congress may have access to the information exchanged, in their capacity of overseeing the administration of the U.S. income tax law, subject to the secrecy requirements applicable to domestic tax information.

Paragraph 2 provides that the obligation to exchange information under this Article does not require a Contracting State to carry out administrative measures contrary to the laws and practice of either State, or to supply information not obtainable in that or the other State under its laws or tax administration, or to supply information which would disclose any trade secret or which it is contrary to the public policy of that State to disclose. For example, if one of the States requests the other to furnish information which the first State could not obtain under its own laws and practice, the second State need not comply with that request even though its laws and practice permit it to collect such information with respect to domestic tax claims.

Paragraph 3 provides that, subject to the conditions of paragraphs 1 and 2, a Contracting State will obtain information requested by the other Contracting State in the same manner and to the same extent as if the tax in question were its own tax, even though it may have no tax interest in the particular case to which the request relates.

It is contemplated that the information exchanged under this Article may be on a routine basis, such as reporting on income payments made and tax withheld, or in response to specific requests. The competent authorities may agree on the items of information to be furnished routinely. They may also agree to furnish information spontaneously which they believe to be relevant in applying the Convention or the domestic laws covered by the Convention and to develop and implement other programs of information exchange within the conditions of this Article.

9.5 US-Israel Double Tax Treaty 1975 (effective date 1 January 1995)

ARTICLE 29: Exchange of Information[69]

1. The competent authorities of the Contracting States shall exchange such information as is pertinent to carrying out the provisions of this Convention or preventing fraud or fiscal evasion in relation to the taxes which are the subject of this Convention. Any information so exchanged shall be treated as secret and shall not be disclosed to any persons or authorities other than those concerned with the assessment (including judicial determination), collection, or administration of the taxes which are the subject of the Convention.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on one of the Contracting States the obligation:

(a) to carry out administrative measures at variance with the laws or the administrative practice of that or of the other Contracting State;

(b) to supply particulars which are not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

[69] Convention between the United States and Israel signed in Washington on 20 November 1975, as modified by a protocol signed on 30 May 1980 and a protocol signed on 26 January 1993. Available from <http://www.irs.gov/pub/irs-trty/israel.pdf>.

(c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy.

EXCHANGE OF NOTES TO THE 1975 DTA, V, (1980)

May 30, 1980

His Excellency Ephraim Evron,
Ambassador of Israel

Excellency: I have the honor to refer to the Convention between the Government of the United States of America and the Government of the State of Israel with respect to taxes on income signed at Washington on November 20, 1975 and amended by a Protocol which was signed today, and to confirm on behalf of the Government of the United States of America, the following understanding reached between the two Governments.

The Government of the United States and the Government of Israel agree that exchange of information shall be made in accordance with Article (Exchange of information) of the Convention.

It is understood, however, that due to a lack of technical capability, and to a severe manpower shortage in revenue administration in Israel, it is impractical, at this time, for the Government of Israel to exchange information on a routine basis with respect to receipts from Israel of dividends, interest and royalties by residents of the United States as well as any information not existing in the Finance Minister's files. However, as soon as the above deficiencies are remedied, the Government of Israel will provide information made available by advances in its capability of acquiring and compiling tax information.

I have the honor to propose that this note and your Excellency's reply confirming the above points of understanding on behalf of your Government shall be regarded as constituting an agreement between our two Governments concerning this matter, which will enter into force on the date of the entry into force of the Convention between the Government of the United States of America and the Government of the State of Israel with respect to taxes on income, signed at Washington November 20, 1975.

Accept, Excellency, the renewed assurances of my highest consideration.

For the Secretary of State:
Harold H. Saunders.

9.6 US-Turkey Double Tax Treaty 1996 (effective 1 January 1998)

ARTICLE 26: Exchange of Information[70]

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Agreement or of the domestic laws of

[70] Available at <http://www.unclefed.com/ForTaxProfs/Treaties/turkey.pdf>.

the Contracting States concerning taxes covered by the Agreement insofar as the taxation thereunder is not contrary to the Agreement. The exchange of information is not restricted by Article 1 (Personal Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Agreement. Such persons or authorities shall use the information only for such purposes.
They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

a) to carry out administrative measures at variance with the laws and the administrative practice of that or of the other Contracting State;
b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

3. If the information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State, to the maximum extent possible under the laws and administrative practices and procedures of that other State, shall provide information under this Article in a form consistent with the purposes of the request.

4. For the purposes of this Article, the Agreement shall apply, notwithstanding the provisions of Article 2 (Taxes Covered), to taxes of every kind imposed by a Contracting State.

US TREASURY TECHNICAL EXPLANATION OF US-TURKEY DTA

Article 26 Exchange of information

Paragraph 2

Paragraph 2 explains that the obligations undertaken in paragraph 1 to exchange information do not require a Contracting State to carry out administrative measures that are at variance with the laws or administrative practice of either State. Nor is either State obliged to supply information not obtainable under the laws or administrative practice of either State, or to disclose trade secrets or other information, the disclosure of which would be contrary to public policy (ordre public). However, either Contracting State may, subject to the limitations of this paragraph and its internal law, provide information which it is not obligated to provide under this Article.

It is understood that information contained in banking documents, including, for example, banking documents pertaining to third persons involved in transactions with residents of either Contracting State, will be made available under this Article. Thus, any domestic laws regarding bank secrecy will not be invoked to prevent or undermine the effective exchange of information or documents under this Article.

9.7 US-Switzerland Double Tax Treaty 1996 (effective 1 January 1998)

Article 22: Limitation of benefits

The competent authorities of the Contracting States shall consult together with a view to developing a commonly agreed application of the provisions of this Article. The competent authorities shall, in accordance with the provisions of Article 26 (Exchange of information), exchange such information as is necessary for carrying out the provisions of this Article.

Article 26: Exchange of information

1. The competent authorities of the Contracting States shall exchange such information (being information available under the respective taxation laws of the Contracting States) as is necessary for carrying out the provisions of the present Convention or for the prevention of tax fraud or the like in relation to the taxes which are the subject of the present Convention. In cases of tax fraud, (a) the exchange of information is not restricted by Article 1 (Personal scope) and (b) if specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of authenticated copies of unedited original records or documents. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic law of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. No information shall be exchanged which would disclose any trade, business, industrial or professional secret or any trade process.

2. Each of the Contracting States may collect such taxes imposed by the other Contracting State as though such taxes were the taxes of the former State as will ensure that the exemption or reduced rate of tax granted under Articles 10 (Dividends), 11 (Interest), 12 (Royalties) and 18 (Pensions and annuities) of the present Convention by such other State shall not be enjoyed by persons not entitled to such benefits.

3. In no case shall the provisions of this Article be construed so as to impose upon either of the Contracting States the obligation to carry out administrative measures at variance with the regulations and practice of either Contracting State or which would be contrary to its sovereignty, security or public policy or to supply particulars which are not procurable under its own legislation or that of the State making application.

4. The competent authorities may release to an arbitration board established pursuant to paragraph 6 of Article 25 (Mutual agreement procedure) such information as is necessary

for carrying out the arbitration procedure. The members of the arbitration board shall be subject to the limitations on disclosure described in this Article.

US-Switzerland DTA Protocol 1996

With reference to Article 26 (Exchange of information)

The parties agree that the term "tax fraud" means fraudulent conduct that causes or is intended to cause an illegal and substantial reduction in the amount of tax paid to a Contracting State.

Fraudulent conduct is assumed in situations where a taxpayer uses, or has the intention to use, a forged or falsified document such as a double set of books, a false invoice, an incorrect balance sheet or profit and loss statement, or a fictitious order or, in general, a false piece of documentary evidence, and in situations where the taxpayer uses, or has the intention to use, a scheme of lies ("Lügengebäude") to deceive the tax authorities. It is understood that the acts described in the preceding sentence are by way of illustration, not by way of limitation. The term "tax fraud" may in addition include acts that, at the time of the request, constitute fraudulent conduct with respect to which the requested Contracting State may obtain information under its laws or practices.

It is understood that, in determining whether tax fraud exists in a case involving the active conduct of a profession or business (including a profession or business conducted through a sole proprietorship, partnership or similar enterprise), the requested State shall assume that the record-keeping requirements applicable under the laws of the requesting State are the record-keeping requirements of the requested State.

EXCHANGE OF NOTES

Washington, October 2, 1996

Dear Mr. Secretary,

I have the honor to confirm the receipt of your Note of today's date which reads as follows:

"Excellency:

I have the honor to refer to the Convention signed today between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income and to the Protocol also signed today which forms an integral part of the Convention and to propose on behalf of the Government of the United States the following:

In the course of the negotiations leading to the conclusion of the Convention and the Protocol signed today, the negotiators developed and agreed upon the Memorandum of Understanding that is attached to this Note. The Memorandum of Understanding is a statement of intent setting forth a common understanding and interpretation of certain provisions of the Convention reached by the delegations of the Swiss Confederation and

the United States acting on behalf of their respective governments. These understandings and interpretations are intended to give guidance both to the taxpayers and the tax authorities of our two countries in interpreting these provisions.

If the understandings and interpretations in the Memorandum of Understanding are acceptable, this note and your note reflecting such acceptance will memorialize the understandings and interpretations that the parties have reached.

MEMORANDUM OF UNDERSTANDING (1996)

8. In reference to Article 26 (Exchange of information)

(a) The definition of tax fraud applicable for purposes of Article 26 of this Convention shall apply in cases where a Contracting State may need to resort to other legal means applicable to mutual assistance between the Contracting States in matters involving tax fraud, such as the Swiss Federal Law on International Mutual Assistance in Criminal Matters of 20 March, 1981, in order to obtain certain types of assistance, such as the deposition of witnesses.

(b) The term "records or documents" used in Article 26 is an all- inclusive term covering all forms of recorded information whether held by public or private individuals or entities.

(c) Persons or authorities to whom information is disclosed in accordance with paragraph 1 of Article 26 may disclose the information in public court proceedings or in judicial decisions.

(d) It is understood that in cases of tax fraud Swiss banking secrecy does not hinder the gathering of documentary evidence from banks or its being forwarded under the Convention to the competent authority of the United States of America.

9.8 US-Venezuela Double Tax Treaty 1999 (effective 1 January 2000)

ARTICLE 27: Exchange of Information[71]

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1 (General Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

[71] Available at <http://www.ustreas.gov/offices/tax-policy/library/venezula.pdf>.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:
a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
b) to supply information that is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
c) to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy.

3. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

4. For the purposes of this Article, the Convention shall apply, notwithstanding the provisions of Article 2 (Taxes Covered), to taxes of every kind imposed by a Contracting State.

PROTOCOL TO US-VENEZUELA DTA 1999

19. With respect to Article 27 (Exchange of Information)

It is understood that in order to comply with the provisions contained in Article 27 (Exchange of Information) the competent authorities of the Contracting States are empowered by their respective domestic laws to obtain information held by persons other than taxpayers, including information held by financial institutions, agents and trustees.

9.9 US-Luxemburg Double Tax Treaty 1996 (effective 1 January 2001)

Article 28 Exchange of information

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by this Convention insofar as the taxation thereunder is not contrary to this Convention. The exchange of information is not restricted by Article 1 (General scope). Any information received by the competent authority of a Contracting State from the competent authority of the other Contracting State shall be treated as secret in the same manner as information obtained under the domestic law of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the

information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

(a) to carry out administrative measures at variance with the laws and administrative practice of that State or of the other Contracting State;
(b) to supply information which is not obtainable under the laws or in the normal course of the administration of that State or of the other Contracting State;
(c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

3. Where information is requested by a Contracting State through competent authorities, the competent authority of the other Contracting State shall obtain the information to which the request relates in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writing) to the same extent that the competent authority of the other Contracting State can obtain such depositions and documents for an investigation or proceeding under its laws and administrative practice.

4. The Contracting States undertake to lend each other support and assistance in the collection of taxes to the extent necessary to ensure that relief granted by the present Convention from taxation imposed by a Contracting State does not inure to the benefit of persons not entitled thereto. With respect to a specific request for collection assistance:

(a) the requesting State must produce a copy of a document certified by its competent authority specifying that the sums referred to it for the collection of which it is requesting the intervention of the other State, are finally due and enforceable;
(b) A document produced in accordance with the provisions of this paragraph shall be rendered enforceable in accordance with the laws of the requested State;
(c) the requested State shall effect recovery in accordance with the rules governing the recovery of similar tax debts of its own; however, tax debts to be recovered shall not be regarded as privileged debts in the requested State; and
(d) appeals concerning the existence or amount of the debt shall lie only to the competent tribunal of the requesting State.

The provisions of this paragraph shall not impose upon either Contracting State the obligation to carry out administrative measures that would be contrary to its sovereignty, security, public policy or its essential interests.

EXCHANGE OF NOTES 1996
3 April 1996

Excellency,

I have the honour to refer to the Convention between the Government of the United States of America and the Government of the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to taxes on Income and Capital (the "Convention") and to propose on behalf of the Government of the United States the following:

In the course of the negotiations leading to the conclusion of the Convention, the negotiators developed and agreed upon a common understanding and interpretation of the following provisions. These understandings and interpretations are intended to give guidance both to the taxpayers and the authorities of our two countries in interpreting various provisions contained in the Convention.

…

IV. With reference to Article 28 (Exchange of information)

Paragraph 1 of Article 28 requires that each Contracting State provide to the other the broadest possible measure of assistance with respect to matters covered by the Convention. The Contracting States expect that the authorities in each State, including judicial authorities to the extent that they become involved in executing a request, will use their best efforts to provide the assistance requested.

Also, under paragraph 3, upon request the competent authority of a Contracting State will obtain and provide information, other than information of financial institutions, for any matter relating to the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention, but only in the same manner and to the same extent as if the competent authority of the requested State were obtaining the information for an investigation or a public court proceeding under its laws and practices. Thus, upon request the competent authority of the requested State shall obtain and provide authenticated copies of third-party books and records located in the requested State for any tax investigation or proceeding in the requesting State, so long as the laws and practices of the requested State would allow its tax authorities to obtain such information for an investigation or a public court proceeding under its laws.

Finally, it is understood that certain information of financial institutions may be obtained and provided to certain U.S. authorities only in accordance with the terms of the Treaty between the United States of America and the Grand Duchy of Luxembourg on Mutual Legal Assistance in Criminal Matters. The scope of this obligation is set forth in that agreement. Further, if the laws and practices in Luxembourg change in a way that permits the Luxembourg competent authority to obtain such information for purposes of enforcing and administering its tax laws or the tax laws of member States of the European Union, it is understood that such information will be obtained and provided to the U.S. competent authority to the same extent that it is obtained and provided for the enforcement and administration of such tax laws.

US Treasury Technical Explanation of the US-Luxembourg DTA 1996

Article 28

Exchange of information

This Article provides for the exchange of information between the competent authorities of the Contracting States and for the provision of certain assistance in the collection of taxes. The memorandum of understanding provides that each Contracting State provide the other the broadest possible measure of assistance with respect to matters covered by the Convention, and the Contracting States expect that the authorities in each State, including judicial authorities to the extent they become involved in executing a request, will use their best efforts to provide the assistance requested.

Paragraphs 1 through 3 provide for the exchange of information. Paragraph 1 provides that the information to be exchanged is that necessary for carrying out the provisions of the Convention or the domestic laws of the United States or Luxembourg concerning the taxes covered by this Convention. Paragraph 1, Article 2, specifies that, for the United States, the Convention shall apply to all federal income taxes, except for social security taxes, and federal excise taxes imposed on insurance premiums paid to foreign insurers, except for excise taxes imposed on premiums paid to foreign insurers for reinsurance.

The exchange of notes makes clear that upon request the Luxembourg competent authority will obtain and provide information, other than information of Luxembourg financial institutions, for any matter relating to the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Thus, under Article 28 U.S. tax authorities can obtain such information for both civil and criminal tax matters. Although the exchange of notes limits the latter obligation to the same manner and to the same extent as if the Luxembourg competent authority were obtaining the information for an investigation or public court proceeding under its laws and practices, the Luxembourg competent authority has adequate authority to compel the production of a wide variety of information, whether in the form of statements of individuals or documents, such as the books and records of a business, located in Luxembourg, pursuant to a request for information from the U.S. competent authority.

On the other hand, because Luxembourg tax authorities are prohibited under Luxembourg law from obtaining information from Luxembourg financial institutions for their own tax investigations and proceedings, Luxembourg was unable to agree to any provision in the Tax Convention which would obligate the Luxembourg competent authority to obtain such information upon the request of U.S. competent authority for use in U.S. tax investigations or proceedings. To allow U.S. authorities another channel for obtaining information of Luxembourg financial institutions, the exchange of notes makes clear that information of Luxembourg financial institutions may be provided to U.S. authorities only in accordance with the terms of the Treaty between the United States of America and the Grand Duchy of Luxembourg on Mutual Legal Assistance in Criminal Matters (hereinafter "MLAT").

Paragraph 1 states that information exchange is not restricted by Article 1 (General scope). This means that information may be requested and provided under this Article with respect to persons who are not residents of either Contracting State. For example, if a third-country resident has a permanent establishment in Luxembourg which engages in transactions with a U.S. enterprise, the United States could request information with respect to that permanent establishment, even though it is not a resident of either

Contracting State. Similarly, if a third-country resident maintains a bank account in Luxembourg, the United States could request and obtain information under the MLAT with respect to that person's account to the same extent that it could request the information regarding a resident of Luxembourg or the United States.

Paragraph 1 also provides assurances that any information exchanged will be treated as secret, subject to the same disclosure constraints as information obtained under the laws of the requesting State. Information received may be disclosed only to persons or authorities, including courts and administrative bodies, involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by this Article. The information may be used by these persons or authorities only in connection with these designated functions, but may disclose information exchanged in public court proceedings or in judicial proceedings.

It is understood that the reference in Paragraph 1 to administration includes persons involved in the oversight of the administration of taxes in the United States, i.e., the appropriate committees of the U.S. Congress as well as the U.S. General Accounting Office, where such access is necessary to carry out their oversight responsibilities. Information received by these bodies is for use in the performance of their role in overseeing the administration of U.S. tax laws.

Paragraph 2 explains that the obligations undertaken in paragraph 1 to exchange information do not require a Contracting State to carry out administrative measures which are at variance with the laws or administrative practice of either State. Nor does that paragraph require a Contracting State to supply information not obtainable under the laws or administrative practice of either State, or to disclose any trade, business, industrial, commercial or professional secret or trade process, or other information, the disclosure of which would be contrary to public policy.

Paragraph 3 and the exchange of notes provide that when information is requested by a competent authority of Contracting State in accordance with this Article, the competent authority of the other Contracting State is obligated to obtain the requested information as if the competent authority of that Contracting State were obtaining the requested information for an investigation or public court proceeding under its own laws and practices. The paragraph further provides that the requesting State may specify the form in which information is to be provided (e.g., depositions of witnesses and authenticated copies of original documents) so that the information can be usable in the judicial proceedings of the requesting State. The requested State should, if possible, provide the information in the form requested to the same extent that it can obtain the requested information in that form for an investigation or public court proceeding under its own laws and practices.

Paragraph 4 provides for assistance in collection of taxes to the extent necessary to ensure that treaty benefits are enjoyed only by persons entitled to those benefits under the terms of the Convention. Under this paragraph, a Contracting State will endeavor to collect on behalf of the other State only those amounts necessary to ensure that any exemption or reduced rate of tax at source granted under the Convention by that other State is not enjoyed by persons not entitled to those benefits.

Subparagraphs (a), (b), (c) and (d) of paragraph 4 impose conditions on collection assistance. Under subparagraph (a), the requesting State must produce a copy of a document certified by its competent authority specifying that the sums referred for collection assistance are finally due and enforceable. The tax of a requesting State shall be considered "finally due and enforceable" when the requesting State has the right under its internal law to collect the tax and all administrative and judicial rights of the taxpayer to restrain collection in the requesting State have lapsed or been exhausted. Thus, the concept of "finally due and enforceable" is equivalent to "finally determined" in the U.S. income tax treaties with Canada and the Netherlands.

Under subparagraph (b), a document described in subparagraph (a) shall be rendered enforceable in accordance with the laws of the requested State. For example, where the U.S. Competent Authority accepts a request for collection assistance, the Luxembourg tax claim shall be treated by the United States as an assessment under United States laws against the taxpayer as of the time the request is received.

Under subparagraph (c), the requested State shall effect recovery in accordance with the rules governing the recovery of similar tax debts of its own; however, tax debts to be recovered shall not be regarded as privileged debts in the requested State. This provision establishes the rule that a tax for which collection assistance is provided shall not have in the requested State any priority specially accorded to the taxes of the requested State. Thus, the priority enjoyed by the requested State for collection of its own taxes in relation to conflicting creditor claims (e.g., in bankruptcy) are not automatically extended to the tax claims of the requesting state.

Where the U.S. competent authority accepts a request for collection assistance, and judicial enforcement is required to effect such assistance, judicial enforcement will be requested and the matter will be referred to the Department of Justice as if the Luxembourg tax claim were a U.S. tax assessment.

Under subparagraph (d), appeals concerning the existence or amount of the debt shall lie only to the competent tribunal of the requesting State. Finally, paragraph 7 provides that the Contracting State asked to collect the tax is not obligated, in the process, to carry out administrative measures that would be contrary to its sovereignty, security, public policy or essential interests. Essential interests are not defined in the Convention, but bank secrecy is understood not to be an essential interest.

The exchange of notes provides that if the laws and practices in Luxembourg change in a way that permits the Luxembourg competent authority to obtain information from Luxembourg financial institutions for the purposes of enforcing and administering its tax laws or the tax laws of member states of the European Union, it is understood that such information will be obtained and provided to the U.S. competent authority to the same extent that it is obtained and provided for the enforcement and administration of the former laws.

9.10 US-Sri Lanka Double Tax Treaty 1985 (effective 1 January 2004)

Article 27 Exchange of information and administrative assistance

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention, as well as to prevent fiscal evasion. The exchange of information is not restricted by Article 1 (Personal scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

(a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
(b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
(c) to supply information which would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy (ordre public).

3. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain the information to which the request relates in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

4. Each of the Contracting States shall endeavour to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by the Convention from taxation imposed by that other State does not enure to the benefit of persons not entitled thereto.

5. Paragraph 4 of this Article shall not impose upon either of the Contracting States the obligation to carry out administrative measures which are of a different nature from those used in the collection of its own taxes, or which would be contrary to its sovereignty, security, or public policy.

6. For the purposes of this Article, the Convention shall, notwithstanding the provisions of Article 2 (Taxes covered), apply:

(a) in relation to the United States, to taxes of every kind imposed at the national level; and

(b) in relation to Sri Lanka, to all taxes administered by the Commissioner-General of Inland Revenue.

US Department of the Treasury Technical Explanation of the US-Sri Lanka DTA.

See <http://www.ustreas.gov/press/releases/reports/tesrlanka04.pdf> at pp82-83.

Article 27 (Exchange of Information and Administrative Assistance)

….

Paragraph 2

Paragraph 2 provides that the obligations undertaken in paragraph 1 to exchange information do not require a Contracting State to carry out administrative measures that are at variance with the laws or administrative practice of either State. Nor is a Contracting State required to supply information not obtainable under the laws or administrative practice of either State, or to disclose trade secrets or other information, the disclosure of which would be contrary to public policy. Thus, a requesting State may be denied information from the other State if the information would be obtained pursuant to procedures or measures that are broader than those available in the requesting State. However, each Contracting State has confirmed in the Notes its ability to obtain and exchange certain information under Article 27. The information that may be exchanged includes information held by financial institutions, nominees or persons acting in an agency or fiduciary capacity (not including information that would reveal confidential communications between a client and an attorney, where the client seeks legal advice). In the case of the United States, the scope of the privilege for such confidential communications is co-extensive with the attorney-client privilege under U.S. law. The Contracting States may also obtain and exchange information relating to the ownership of legal persons.

Annex 10 Exchange of Information: OECD Revises Model July 2004

This OECD press release announces the most recent OECD development on exchange of information. It was issued on 23 July, 2004.

OECD Releases New Provisions for Exchange of Information
Between Tax Authorities

23/07/2004 - The OECD's Committee on Fiscal Affairs has agreed on new provisions for the exchange of information between national tax authorities as part of a drive for improved co-operation to assist in the administration of domestic tax laws and international tax treaties.

The new arrangements are set out in a revised version of Article 26 of the OECD's Model Tax Convention, which covers the exchange of information on tax matters. The provisions of Article 26 are widely accepted as providing the international standard for exchange of information between tax authorities. In its updated version, Article 26 now reflects current practices in many countries as well as an agreement between OECD countries on the ideal standard of access to bank information for tax purposes.

Bill McCloskey, Chair of the OECD's Committee on Fiscal Affairs, welcomed the conclusion of this work, which marks the first comprehensive revision of the Model Tax Convention's exchange of information provisions since 1977. More than 2000 bilateral tax treaties are based on the OECD Model Tax Convention.

In today's globalised economy, he noted, effective information exchange is essential for countries to maintain sovereignty over the application and enforcement of their tax laws and to ensure the correct application of tax conventions. Given that an increasing number of taxpayers are engaging in cross border activity, tax authorities need an effective legal mechanism for obtaining information from their treaty partners to ensure compliance with the tax laws. While taxpayers can operate in a global world relatively unconstrained by national borders, tax authorities must respect these borders in carrying out their functions. Exchange of information provisions offer a legal framework for co-operating across borders without violating the sovereignty of other countries or the rights of taxpayers.

"Article 26 now reflects the new international standard of information exchange in tax matters," Mr. McCloskey said in a statement. "The vast majority of OECD member countries already meet the new standard and I am looking forward to other countries, both inside and outside the OECD, moving towards the standard of information exchange now found in Article 26."

The key changes in Article 26 are as follows:

A new paragraph has been added to prevent "domestic tax interest" requirements from hindering exchange of information. A domestic tax interest requirement refers to laws or practices that would prohibit one treaty partner from obtaining or exchanging information requested by another treaty partner unless the requested treaty partner had an interest in such information for its own tax purposes. The new paragraph clarifies

that Contracting States should obtain and exchange information irrespective of whether they also need the information for their own tax purposes.

A new paragraph has been added to ensure that ownership information and information held by banks, financial institutions, nominees, agents and fiduciaries can be exchanged. New paragraph 5 prevents bank secrecy from being used as a basis for refusing to exchange information.

The confidentiality rules in Article 26 have been changed so as to permit disclosure of information to oversight authorities. This change reflects a growing trend in OECD countries. Oversight authorities are authorities that supervise tax administration and enforcement authorities as part of the general administration of the government of a Contracting State.

These and other changes made to Article 26 and its Commentary are consistent with the 2002 Model Agreement on Exchange of Information in Tax Matters, which was developed jointly with a number of non-member economies committed to the principles of transparency and effective exchange of information.

For further information, journalists are invited to contact Helen Fisher, OECD's Media Relations Division (tel. 33 1 45 24 80 97).

Annex 11 Limitation of Benefits in Canada-US DTA

Canada-USA Double Tax Treaty 1980

Article XXIXA: Limitation on benefits

1. For the purposes of the application of this Convention by the United States,
(a) a qualifying person shall be entitled to all of the benefits of this Convention, and
(b) except as provided in paragraphs 3, 4 and 6, a person that is not a qualifying person shall not be entitled to any benefits of the Convention.

2. For the purposes of this Article, a qualifying person is a resident of Canada that is:
(a) a natural person;
(b) the Government of Canada or a political subdivision or local authority thereof, or any agency or instrumentality of any such government, subdivision or authority;
(c) a company or trust in whose principal class of shares or units there is substantial and regular trading on a recognized stock exchange;
(d) a company more than 50% of the vote and value of the shares (other than debt substitute shares) of which is owned, directly or indirectly, by five or fewer persons each of which is a company or trust referred to in subparagraph (c), provided that each company or trust in the chain of ownership is a qualifying person or a resident or citizen of the United States;
(e) (i) a company 50% or more of the vote and value of the shares (other than debt substitute shares) of which is not owned, directly or indirectly, by persons other than qualifying persons or residents or citizens of the United States, or

(ii) a trust 50% or more of the beneficial interest in which is not owned, directly or indirectly, by persons other than qualifying persons or residents or citizens of the United States,
where the amount of the expenses deductible from gross income that are paid or payable by the company or trust, as the case may be, for its preceding fiscal period (or, in the case of its first fiscal period, that period) to persons that are not qualifying persons or residents or citizens of the United States is less than 50% of its gross income for that period;
(f) an estate;
(g) an estate;
(h) an organization described in paragraph 2 of Article XXI (Exempt organizations) and established for the purpose of providing benefits primarily to individuals who are qualifying persons, persons who were qualifying persons within the five preceding years, or residents or citizens of the United States.

3. Where a person that is a resident of Canada and is not a qualifying person of Canada, or a person related thereto, is engaged in the active conduct of a trade or business in Canada (other than the business of making or managing investments, unless those activities are carried on with customers in the ordinary course of business by a bank, an insurance company, a registered securities dealer or a deposit-taking financial institution), the benefits of the Convention shall apply to that resident person with respect to income derived from the United States in connection with or incidental to that trade or business, including any such income derived directly or indirectly by that resident person through one or more other persons that are residents of the United States. Income shall be deemed to be derived from the United States in connection with the active conduct of a trade or business in Canada only if that trade or business is substantial in relation to the activity

carried on in the United States giving rise to the income in respect of which benefits provided under the Convention by the United States are claimed.

4. A company that is a resident of Canada shall also be entitled to the benefits of Articles X (Dividends), XI (Interest) and XII (Royalties) if

(a) its shares that represent more than 90% of the aggregate vote and value represented by all of its shares (other than debt substitute shares) are owned, directly or indirectly, by persons each of whom is a qualifying person, a resident or citizen of the United States or a person who
(i) is a resident of a country with which the United States has a comprehensive income convention and is entitled to all of the benefits provided by the United States under that convention;
(ii) would qualify for benefits under paragraphs 2 or 3 if that person were a resident of Canada (and, for the purposes of paragraph 3, if the business it carried on in the country of which it is a resident were carried on by it in Canada); and
(iii) would be entitled to a rate of United States tax under the convention between that person's country of residence and the United States, in respect of the particular class of income for which benefits are being claimed under this Convention, that is at least as low as the rate applicable under this Convention; and
(b) the amount of the expenses deductible from gross income that are paid or payable by the company for its preceding fiscal period (or, in the case of its first fiscal period, that period) to persons that are not qualifying persons or residents or citizens of the United States is less than 50% of the gross income of the company for that period.

5. For the purposes of this Article, the term “recognized stock exchange” means:
(i) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934;
(ii) Canadian stock exchanges that are “prescribed stock exchanges” under the Income Tax Act; and
(iii) any other stock exchange agreed upon by the Contracting States in an exchange of notes or by the competent authorities of the Contracting States;
(b) the term "not-for-profit organization" of a Contracting State means an entity created or established in that State and that is, by reason of its not-for-profit status, generally exempt from income taxation in that State, and includes a private foundation, charity, trade union, trade association or similar organization; and
(c) the term "debt substitute share" means:
(i) a share described in paragraph (e) of the definition "term preferred share" in the Income Tax Act, as it may be amended from time to time without changing the general principle thereof; and
(ii) such other type of share as may be agreed upon by the competent authorities of the Contracting States.

6. Where a person that is a resident of Canada is not entitled under the preceding provisions of this Article to the benefits provided under the Convention by the United States, the competent authority of the United States shall, upon that person's request, determine on the basis of all factors including the history, structure, ownership and operations of that person whether

(a) its creation and existence did not have as a principal purpose the obtaining of benefits under the Convention that would not otherwise be available; or
(b) it would not be appropriate, having regard to the purpose of this Article, to deny the benefits of the Convention to that person.
The person shall be granted the benefits of the Convention by the United States where the competent authority determines that subparagraph (a) or (b) applies.

7. It is understood that the fact that the preceding provisions of this Article apply only for the purposes of the applicatio of the Convention by the United States shall not be construed as restricting in any manner the right of a Contracting State to deny benefits under the Convention where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Convention.

Annex 12 Tax Avoidance Schemes Using DTAs

12.1 Tax Planning Using DTAs: Some Recent Developments (June 2004)

Jordan has signed but not yet completed all of the legal procedures to implement comprehensive DTAs with the Netherlands and Malta. Jordan has also exchanged a DTA proposal with Cyprus.

This report by Christian Pellone of PricewaterhouseCoopers (PwC) shows how recent DTAs negotiated in the Asia Pacific and in Europe can be used to ensure that little or no income tax in any country is paid on foreign investment. The report is in Issue No 17 of the PwC *Asia Pacific Tax Notes*, June 2004 available at the following url:

<http://www.pwchk.com/home/webmedia/1086675710583/aptn17_lead_article.pdf>.

12.2 Tax Avoidance Schemes Using Tax Sparing Provisions in DTAs

Annexes IV & V in OECD, *Tax Sparing* (1987) C(97)184

C(97)184

ANNEX IV

TAX AVOIDANCE SCHEME I

The conduit-scheme example described below has been reproduced from the New Zealand note SG/EMEF/CFA(96)18 to the EMEF meeting in Paris on 26-27 September 1996.

The following scheme is designed effectively to offset tax sparing credits against tax liabilities that do not relate to the foreign investment which gave rise to the tax sparing credit. The scheme has particular application in situations where the taxpayer has excess tax sparing credits. The scheme came to New Zealand's attention three years ago and precipitated renegotiation of the tax sparing provision in six of New Zealand's treaties to include an anti-avoidance rule to stop the scheme. Two of the schemes discovered involved loans of hundreds of millions of US dollars. More recently, during an audit of an international financial institution, we discovered correspondence confirming that the scheme is being used in Asia.

Tax sparing provisions in tax treaties are intended to prevent the home country clawing back a tax incentive by the host country. Where there is no tax liability in the home country in respect of the income that is spared by the host country, the tax sparing credits should not, in principle, be available to offset the tax liability on other unrelated income. New Zealand's tax law does not allow foreign tax credits (including tax sparing credits) to offset liabilities on other non-related income. However, as the examples below will show, this effect may be achieved by allocating the income and expenditure through different legal entities. As a result, this scheme exposes countries that give tax sparing to being used as conduits for loans destined for developing countries. The scheme can erode their existing tax bases by an amount equal to the value of the tax spared by the host country.

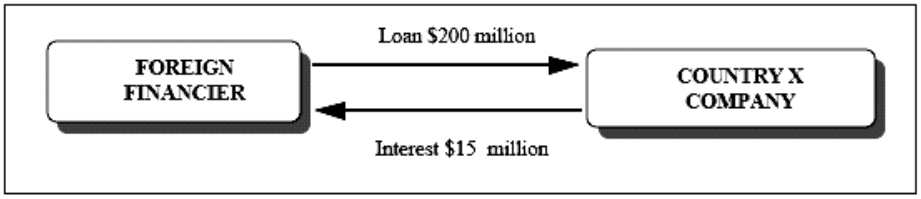
The scheme is illustrated using three scenarios. They assume a company resident in a developing country (Country X) requires a loan of $200 million to fund a development project that is approved under that country's various economic expansion incentives. An international financier ("Foreign Financier") agrees to lend the money at a rate of 7.5% per annum.

Scenario one - direct loan from Foreign Financier to Country X Company

This scenario illustrates the substance of the transactions that are outlined in the examples that follow: $200 million is loaned by Foreign Financier to "Country X Company", a company resident in Country X which offers a number of tax concessions, including a tax exemption for interest paid to non-residents.

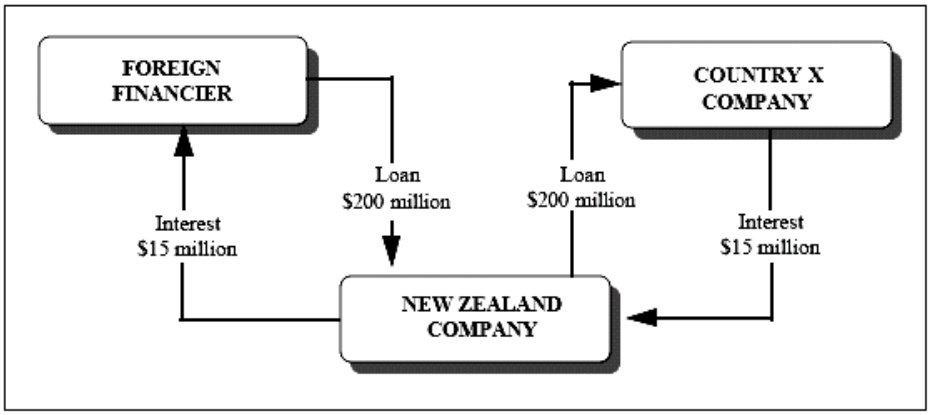
Under this scenario $15 million interest is paid by Country X Company to Foreign Financier. No tax is imposed in Country X since the interest is exempt under one of Country X's economic expansion incentives. Foreign Financier may or may not be taxed on the $15 million interest income, depending on the tax system in the country in which it is resident.

38



Scenario two - loan from Foreign Financier to Country X Company, but loan is channelled through a New Zealand company

This is similar to scenario one, except the loan is channelled through New Zealand. The New Zealand part of the transaction is essentially a back-to-back loan arrangement. "New Zealand Company" earns $15 million interest income but is entitled to a tax deduction of the $15 million interest expense that relates to the income. We assume that New Zealand has granted tax sparing to Country X on this interest income at a rate of 10%, being the maximum tax on gross interest typically set under our tax treaties.



The tax consequences are as follows:

- Country X: No Country X tax is imposed because the tax is spared under one of Country X's economic expansion incentives.
- New Zealand: New Zealand Company pays no New Zealand tax since its net profit is nil (interest income equals its interest expenses). Tax credits for tax spared under the New Zealand/Country X tax treaty are not used, therefore, as there is no New Zealand tax liability.
- The interest income paid from New Zealand to Foreign Financier may be subject to either interest withholding tax of 10% to 15%, or a 2% levy.[6]

[6] The rate may be set by a tax treaty or domestic law and some instruments are exempt from income tax but subject to a levy.

– Foreign Country: Foreign Financier may or may not be subject to tax, depending on the tax system in the country in which it is resident.

In summary, nothing is gained by using New Zealand as a conduit for a simple back-to-back financing arrangement.

Scenario three - similar to scenario two, except two New Zealand companies are used - one to soak up the tax sparing credits and the other to accumulate tax losses

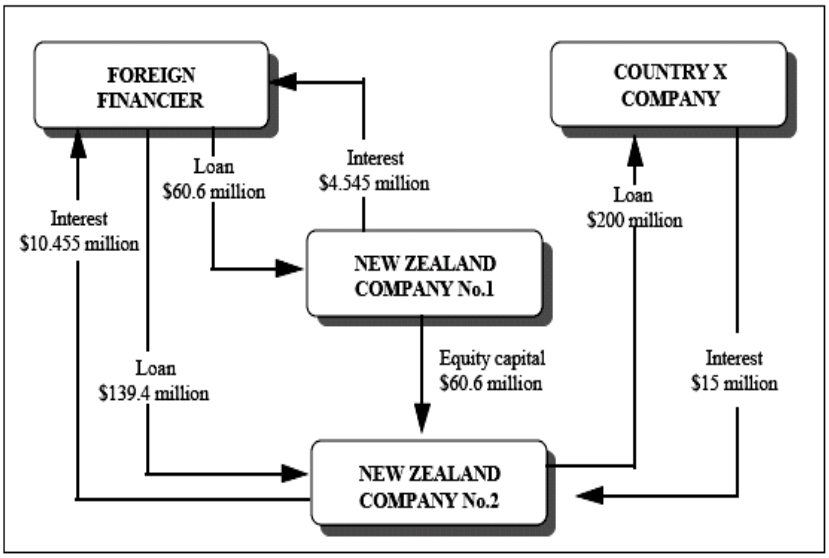
A tax-effective structure ensures that the tax spared credits are soaked up by the recipient company. This is done by splitting the interest expenditure (and loans) between two companies to create a profit in the credit soak-up company. The interest expenses (not required by the tax credit soak-up company) are passed (typically sold) to a profitable New Zealand company that can offset them against other income or accumulate them as tax losses for future use.

As illustrated below, the $200 million loan from Foreign Financier is split between the two New Zealand companies in the following proportions:

– "New Zealand Company No. 1" (NZ Co 1) - $60.6 million; and

– "New Zealand Company No. 2" (NZ Co 2) - $139.4 million.

NZ Co 1 passes the funds that it borrowed ($60.6 million) on to NZ Co 2 by way of an equity capital injection (for example, a purchase of shares in NZ Co 2). NZ Co 2 then lends the full $200 million to Country X Company. We assume again that New Zealand has granted tax sparing to Country X on this interest income at a rate of 10%.



Country X Company pays $15 million interest to NZ Co 2. NZ Co 2 is taxed in New Zealand as follows:

Interest income	15,000,000
Interest expenses	10,454,545
Net profit	4,545,455
Tax on net profit (33%)	1,500,000
Tax sparing credits (10% x $15 million)	(1,500,000)
Tax to pay	Nil

NZ Co 1 has incurred an interest expense of $4,545,455. This translates to a net loss of the same amount on this transaction because it receives no current taxable income from its equity investment in NZ Co 2. This loss can be offset against other income of NZ Co 1 or offset against the income of another company in the same group of companies.

The tax consequences are as follows:

- Country X: No Country X tax is imposed since the tax is spared under one of Country X's economic expansion incentives.

- New Zealand: NZ Co 2 pays no New Zealand tax because its $1,500,000 tax liability is eliminated by a tax sparing credit.

NZ Co 1 is left with a tax loss of $4,545,455 which may be offset against other New Zealand income. The tax benefit of this loss - which is borne by the New Zealand tax base - is $1,500,000 ($4,545,455 x 33%). This is equivalent to the amount of the tax sparing credit.

The interest income paid from New Zealand to Foreign Financier may be subject to either interest withholding tax of 10% to 15%, or a 2% levy

- Foreign Country: Foreign Financier may or may not be subject to tax, depending on the tax system in the country in which it is resident.

By channelling debt investments through a country that grants tax sparing credits, and ensuring that an appropriately tax-planned structure is used to soak up the spared foreign tax credits, a tax benefit equal to the value of the tax spared credits can be obtained. This is contrary to the purpose of tax sparing, which is intended to prevent the home country clawing back the tax incentive of the developing country. It is not there to give a cash subsidy equal to the value of the tax spared by the developing country.

The example has been presented in a simplified form so that the concept can be understood. In the actual schemes that we have encountered, the tax benefit was shared between the foreign financier, a New Zealand company and the company in the developing country (which was to receive a discounted rate of interest). The schemes did not proceed because New Zealand and the treaty partners concerned quickly inserted an anti-avoidance rule in the treaties which permit the New Zealand competent authority to deny tax sparing credit claims if the provision is being abused. This anti-avoidance rule is discussed in more detail later in this paper. We also considered amending New Zealand's domestic law to counter the scheme, but we could not find a suitable remedy. The tax treaty solution appears to have deterred

international financiers from using the treaties concerned, although some financiers have advised that they will instead run the scheme through other countries with tax sparing provisions.

We also became aware of schemes that were to use a structure similar to the one outlined above, except the debt funding was to flow from the developing country to New Zealand and then back to the developing country. The sole purpose of this circular flow of funds would be to exploit the tax sparing provision in the tax treaty. We suspect that the lender and borrower in the developing country were either the same entity or associated entities.

ANNEX V

TAX AVOIDANCE SCHEME II

The routing-scheme example described below has been reproduced from the Australian note SG/EMEF/CFA(96)17 to the EMEF meeting in Paris on 26-27 September 1996.

The largest scheme so far encountered in Australia involves a circular flow of funds. A series of loans were to be purportedly made by an Australian financial institution to a major foreign bank via an intermediary finance company resident in a developing country with which Australia had agreed under a tax treaty to tax spare interest withholding tax forgone by that country under a particular development incentive tax concession. The foreign bank then effectively was to pay the loan moneys back to the Australian financial institution. Interest on such loans were normally subject to 10% interest withholding tax by the developing country. However, the Finance Minister of that country agreed to reduce the interest withholding tax rate on these loans to 1.5% under the relevant development incentive.

Judged against a test of commercial reality, the proposed scheme was artificial and contrived, with the transactions being intended to take place in the space of 30 minutes. Although ostensibly the proposed transactions involved funds of several billion Australian dollars, the transactions were to use only approximately $A 200m, which was to be made available to the intermediary finance company and most of that amount would have been returned immediately to the Australian financial institution in the form of prepaid interest. The scheme would have enabled that financial institution to incur a notional loss which was approximately sufficient in amount to offset the interest income it had earned. The "tax spared" foreign tax credit in respect of the interest withholding tax was to be offset against the tax payable on other foreign income of the financial institution. Over the duration of the scheme the cost to Australian revenue would have been in the order of $A100m. It was only by means of strong representations to its treaty partner that Australia was able to prevent the scheme from being implemented.

12.3 Tax Avoidance Involving 'Cross-Border Insurance Premiums'

Appendix F

Second Protocol Amending the Convention between the Government of New Zealand and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, with Protocol, Signed at the Hague on 15 October 1980

National Interest Analysis

Date of Proposed Binding Treaty Action

The Minister of Foreign Affairs signed the *Second Protocol Amending the Convention between the Government of New Zealand and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, with Protocol, Signed at the Hague on 15 October 1980* (the Second Protocol) on 20 December 2001. Subject to the successful completion of the international treaty examination process, the Second Protocol will be incorporated into domestic legislation through an Order in Council. The Second Protocol will enter into force by way of an exchange of notes between New Zealand and the Netherlands, in which each party will notify the other of the completion of their constitutional requirements for giving effect to the Second Protocol in their respective domestic laws.

Reasons for New Zealand to become a party to the Treaty

2 New Zealand is party to 27 double tax agreements (DTAs), which are primarily aimed at reducing tax impediments to cross-border trade and investment, but which also help tax administrations to detect and prevent tax evasion.

3 The Second Protocol amends a DTA New Zealand has with the Netherlands that came into force in March 1981 and which is more correctly referred to as the *Convention between the Government of New Zealand and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (the DTA). The DTA already stands amended by the *Protocol to the Convention between the Government of New Zealand and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* (the First Protocol), which came into force at the same time as the DTA itself.

4 The Second Protocol was driven primarily by the need to close down a tax avoidance opportunity in New Zealand involving the payment of cross-border insurance premiums to the Netherlands. The opportunity was also taken to make certain other amendments to the DTA to bring it up to date with current DTA and domestic policy in both countries. For instance, the method to be used by the Netherlands for relieving double taxation on certain passive income was altered to reflect Netherlands domestic law, which now adopts the "credit method" rather than the "exemption method". (This amendment has no implications for New Zealand.) In addition, a "non-discrimination" article and an "other

income" article were also inserted into the DTA. The non-discrimination article protects nationals and residents (in certain cases) of both countries from discriminatory tax laws (if any), and needed to be inserted pursuant to a "Most Favoured Nation" obligation contained within the DTA itself. The "other income" article allocates taxing rights in respect of income that is not covered by any other specific article in the DTA, and ensures that no items of income will fall out of the DTA.

Advantages and Disadvantages to New Zealand of the Treaty Entering into Force

5 The Second Protocol will have a number of advantages. The main one is that it closes down a tax loophole involving cross-border insurance premiums. In the absence of this amendment it is possible for profits derived from New Zealand by a non-resident to be characterised as insurance premiums and distributed out of New Zealand without being subject to New Zealand tax. This provision ensures that the DTA can no longer be used to prevent New Zealand from applying its domestic law taxing provisions in such circumstances.

6 An Article dealing with "other income" is also inserted into the DTA. This article is a catch-all article which covers everything not covered by any of the other specific articles in the DTA. This article provides that any "other income" will be taxable in the country in which the recipient is resident. However, if the income arises in the other country it may be taxed in the other country up to a limit of 15% of the gross amount of the income. The advantage of this is that it provides certainty to taxpayers of both countries that no income will fall out of the DTA and be subject to unrelieved double taxation.

7 The Second Protocol also inserts a "non-discrimination" article into the DTA. The advantages of a non-discrimination article for New Zealand are that our nationals operating in the Netherlands are assured of receiving no worse tax treatment than nationals of the Netherlands in the same circumstances. Thus the Netherlands are constrained from applying any discriminatory tax laws against New Zealand nationals.

8 The Protocol does not have any disadvantages to New Zealand.

Obligations

9 Neither the Second Protocol nor the DTA itself (before or after amendment) will impose requirements on taxpayers. The DTA obliges the respective Governments to restrict their taxing rights under domestic law in certain circumstances. In other words, a DTA can only reduce tax already imposed under domestic law; it cannot itself impose tax. The Second Protocol modifies these obligations as follows:

- Article I of the Second Protocol inserts an article in the DTA dealing with "other income". This article is a catch-all article which covers everything not covered by any of the other specific article of the DTA. It provides that any "other income" will be taxable in the country in which the recipient is resident. However, if the income arises in the other country it may also be taxed in that country up to a limit of 15% of the gross amount of the income. The imposes an obligation on New Zealand to limit its taxation of some New Zealand sourced income derived by a resident of the Netherlands (albeit very minor, given that very little income is expected to fall under this article).

- Article III of the Second Protocol inserts a non-discrimination article into the DTA. This article will prevent New Zealand from imposing discriminatory tax laws on nationals of the Netherlands operating in New Zealand, although New Zealand does not currently impose any such discriminatory tax laws and does not propose to introduce any. This article also requires New Zealand to provide no worse treatment to enterprises owned by Netherlands' residents that it applies to enterprises of any other state.
- Article IV of the Second Protocol closes down a tax loophole involving cross-border insurance premiums. This provision permits New Zealand to impose a minimum level of tax on insurance premiums paid to residents of the Netherlands (and vice versa). This new provision is consistent with the position under New Zealand domestic law. It does not create an additional obligation for New Zealand.

Economic, Social, Cultural and Environmental Effects

10 No social, cultural or environmental effects are anticipated. Any economic effects are expected to be favourable, as noted above.

Costs

11 There may be a small revenue cost associated with limiting source taxation on "other income" to 15% from Netherlands residents earning income in New Zealand. However, this revenue cost could be offset by revenue collected by "other income" earned by New Zealand residents in the Netherlands. It may also be offset by tax withheld on insurance premiums paid by New Zealand residents to the Netherlands. We do not expect that any costs will arise in relation to the non-discrimination article.

Future Protocols

12 None anticipated.

Implementation

13 Subject to the successful completion of the international treaty examination process, this DTA will be implemented by Order in Council pursuant to section BH 1(3) of the Income Tax Act 1994.

14 This agreement will be implemented by way of an overriding treaty regulation. Section BH 1 of the Income Tax Act 1994 enables DTAs to be given effect by Order in Council. It also provides that the DTA will override the Income Tax Act 1994 and any other enactment relating to income tax, unpaid tax and the exchange of information relating to a tax. This override is necessary to give effect to the terms of the DTA and will effectively override the Income Tax Act 1994 and the Tax Administration Act 1994.

Consultation

15 The Treasury agrees with the terms of the Protocol.

Withdrawal or Denunciation

16 The Second Protocol can be terminated by terminating the DTA. The DTA can be terminated by giving notice, through diplomatic channels, of termination on or before 30 June in any calendar year.

Prepared by Inland Revenue Department
November 2003

12.4 Tax Planning Using Entities in Labuan, Malaysia by Koreans

Korean Investment Structures – A Cause for Review

Recently, our discussions with the Korean Tax Authorities have indicated that the KTA could be taking a more active role in scrutinising Labuan holding structures. In doing so, the Korean Tax Authorities could immediately, challenge existing Labuan holding structures on the basis that the structure amounts to 'Treaty Shopping.' A longer term approach and alternative (to put the position beyond doubt) is to renegotiate the existing Korea/Malaysia double tax agreement thereby excluding Labuan from the benefit of the Korea/Malaysia double tax agreement.

This latter approach would likely involve a protracted and drawn out process with the respective Governments (and even then may not be effective for some time) some jurisdictions have already gone down this path - most recently, Australia. As a result (after the relevant legal formalities have taken place) the Malaysia/Australia double tax agreement, amongst other things, will exclude Labuan companies from the benefits of the Malaysia/Australia double tax agreement. Whilst we are unsure at this stage what approach the KTA would take there is always a possibility that the Labuan Holding structure could be challenged on the basis of 'Treaty Shopping' - importantly, this is a risk for all investments into Korea via Labuan.

Even though this has always been a technical possibility, previously, such a challenge may not have been high on the KTA's radar. We understand that, the KTA, now, believe that the treaty may be being abused by Korean tax residents investing in Korea via Labuan entities. As a result, these structures could now be on the KTA radar. In the event that the KTA successfully challenged a Labuan holding structure the result would be that capital gains on Korean investments will be subject to Korean CGT at a rate of 30% (not too mention the impact on dividend and interest flows!).

Where to Now?

Whilst no definitive statements have been made by the KTA regarding the path that they will ultimately take, one thing is certain: a successful challenge by the KTA has the capacity to greatly reduce the after tax cash returns to investors. The position to adopt in relation to this risk is likely to be different for each and every situation. Having said this, with planning the risks can be minimised and the current benefits of a Labuan investment structure should be able to be maintained.

See also our commentary on the Malaysia / Australia double tax.

Source: Ernst & Young website

http://www.ey.com/GLOBAL/content.nsf/China_E/Issues_&_Perspectives_-_Article_-_Korean_Investment

Annex 13 DTA Examination by Legislative Committee

Example: New Zealand DTA with United Arab Emirates (2004)

International treaty examination of taxation agreements with the Republic of South Africa, the United Arab Emirates, the Republic of Chile, the United Kingdom of Great Britain and Northern Ireland, the Republic of the Philippines, and the Kingdom of the Netherlands

Report of the Finance and Expenditure Committee

The Finance and Expenditure Committee has conducted an international treaty examination of the following double taxation agreements:

- Agreement between the Government of New Zealand and the Government of the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income
- Agreement between the Government of New Zealand and the Government of the United Arab Emirates for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and Protocol
- Convention Between New Zealand and the Republic of Chile for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Protocol to the Convention between the Republic of Chile and New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income
- Protocol between the Government of New Zealand and the Government of the United Kingdom of Great Britain and Northern Ireland to amend the Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains, signed at London on 4 August 1983
- Protocol amending the Convention between the Government of New Zealand and the Government of the Republic of the Philippines for the avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income

- Second Protocol Amending the Convention between the Government of New Zealand and the Government of the Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, with Protocol, Signed at the Hague on 15 October 1980
- Convention between New Zealand and the Kingdom of the Netherlands for Mutual Assistance in the Recovery of Tax Claims.

We have no matters to bring to the attention of the House.

The National Interest Analyses for these treaties are appended to this report.

Appendix B

Agreement between the Government of New Zealand and the Government of the United Arab Emirates for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and Protocol

National Interest Analysis

Date of Proposed Binding Treaty Action

The Minister of Finance and Revenue signed *the Agreement between the Government of New Zealand and the Government of the United Arab Emirates for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income* and Protocol (the DTA) with the United Arab Emirates (UAE) on 22 September 2003. Subject to the successful completion of the international treaty examination process, the DTA will be incorporated into domestic legislation through an Order in Council. The DTA will enter into force by way of an exchange of notes between New Zealand and the United Arab Emirates, in which each party will notify the other of the completion of their constitutional requirements for giving effect to the DTA in their respective domestic laws.

Reasons for New Zealand to Become a Party to the Treaty

2 New Zealand currently has 27 double tax agreements (DTAs) in force. They are primarily aimed at reducing tax impediments to cross-border trade and investment, but also help tax administrations to detect and prevent tax evasion.

3 DTAs give residents of both countries who are considering entering into cross-border trade and investment greater certainty of tax treatment. DTAs also contain a mutual agreement procedure for resolving disputes or issues that might arise in relation to the DTA. DTAs also assist tax administrations in the prevention of fiscal evasion by providing for the exchange of information on tax matters between two countries.

4 The negotiation of a DTA with the UAE is unusual on one level because the UAE does not have a general income tax system and, therefore, double taxation does not generally arise in cross border transactions between New Zealand and the UAE. The UAE has, however, indicated that it may introduce a general income tax system at some stage in the future.

5 The main rationale for the DTA with the United Arab Emirates is to facilitate investment from the UAE into New Zealand. Due to the absence of a general income tax in the UAE against which New Zealand taxes would otherwise be credited, UAE investors will seek to receive the same after tax rate of return from New Zealand as they can earn elsewhere, including from countries that impose no tax on their investments. Consequently the imposition of full domestic New Zealand tax on UAE investments will, in many cases, result in the UAE investor requiring a rate of return from New Zealand investments which is grossed-up by the amount of New Zealand tax. In essence, UAE

investors are sensitive to New Zealand taxes and the imposition of New Zealand tax on the UAE investor could result in the UAE financing fewer projects in New Zealand. Further, where a higher rate of return is demanded than in the absence of tax, the tax cost would likely be borne by New Zealand factors of production, from whom it would be more efficient to collect the tax directly. Accordingly, this treaty relieves tax on UAE investments in accordance with New Zealand's treaty policy. In particular, UAE investors are likely to be less sensitive to tax on investments which can only be undertaken in New Zealand and the DTA generally retains full taxing rights over investments of this nature.

6 The UAE Government's main investment arm, the Abu Dhabi Investment Authority (ADIA), has significant investments overseas (in excess of US$400 billion). Similarly the Dubai Investment and Development Authority (DIDA) has significant overseas investments, and the UAE private sector is understood to have in the vicinity of US $600 billion available for investors. The UAE government has indicated that it is keen to diversify its investment portfolio into New Zealand as well as increase bilateral trade, joint ventures and education. However, the UAE emphasised that a DTA was a basic pre-requisite for any investment from the UAE due to UAE investors' sensitivity to New Zealand tax.

7 The level of trade is also a major factor in deciding with which countries to negotiate a DTA. The level of imports from and exports to the UAE amounted to $357,068,000 and $108,760,000 respectively for the year ended June 2003.

Advantages and Disadvantages to New Zealand of the Treaty entering into Force

8 The DTA will be advantageous to New Zealand. It follows the standard format of our other DTAs such that New Zealand enterprises dealing with the UAE will be subject to familiar rules. Although the problem of double taxation does not generally arise with the UAE, the significant level of trade between our two countries makes it important that residents of both countries have the comfort of certainty of tax treatment and the benefit of a mutual agreement procedure should they experience taxation difficulties.

9 The main advantage for New Zealand, however, is that the DTA opens up significant opportunities for foreign investment into New Zealand from the UAE. The UAE Government has made it clear that they are willing to look at investing into New Zealand provided a DTA is in place to provide relief from New Zealand taxes. Private sector investment from the UAE into New Zealand also has the potential to increase significantly, given the reduction of withholding tax rates under the DTA.

10 The DTA also advantages New Zealand in that it opens up other opportunities for the UAE to strengthen their relationship with New Zealand, particularly as the UAE have consistently noted that they see New Zealand as a safe, politically stable country. The negotiation of a DTA was a major factor in the decision of the UAE airline Emirates to commence a service to New Zealand. Further it is likely that the DTA will pave the way for fee-paying students to come to New Zealand to study at New Zealand educational institutions.

11 The ability to exchange information with the UAE will also be an advantage for New Zealand, as this will assist in the detection and prevention of tax avoidance and evasion.

12 The disadvantage of the DTA is that by allocating taxing rights between the two countries, New Zealand may forego revenue on any existing UAE investments. However, as mentioned in the discussion of the revenue implications of the DTA under the heading "Costs", UAE investment in New Zealand is likely to be neligible in the absence of a DTA.

13 A detailed aspect of this DTA is that it provides in the Protocol that the Contracting States recognise that sovereign immunity from income tax is provided to the Governments of both countries, including agencies that form an integral part of the Government. This provision clarifies that the DTA recognises and protects (but does not extend), the sovereign immunity doctrine that New Zealand applies to all countries.

14 Consistent with international norms, a restrictive doctrine of sovereign immunity operates in New Zealand. Under this doctrine immunity from judicial suit is provided only in respect of Government acts of a Government nature. It does not provide immunity for Government acts of a commercial nature. Therefore, if the UAE Government enters a transaction of a type that is open to a private citizen the act will be considered commercial or private in nature and sovereign immunity will not apply.

15 Any transactions falling outside the ambit of sovereign immunity will be taxed in New Zealand in accordance with the terms of the articles in the treaty. There is provision for special relief for Government and certain Government owned entities in these articles. Under paragraph 9 of the Protocol the Abu Dhabi Investment Authority and the Dubai Investment and Development Authority are recognised as government institutions that form an integral part of the UAE.

16 On balance, New Zealand stands to gain significant foreign direct investment from the implementation of the DTA and therefore, it is considered that it is in New Zealand's interests to enter into the DTA.

Obligations

17 The DTA does not impose requirements on taxpayers. The obligations it does impose are on the countries to the treaty and restricts their taxing rights under domestic law on a reciprocal basis. (A DTA can only reduce tax already imposed under domestic law; it cannot impose tax.)

18 Under domestic law, New Zealand taxes its residents based on their New Zealand and worldwide income. Non-residents are taxed only on their New Zealand-sourced income. The UAE has a limited income tax system for oil companies and foreign owned banks. The DTA provides a way of allocating taxing rights as between New Zealand and the UAE. Under this DTA, New Zealand and the UAE will be required to comply with the following rules when imposing tax on residents of either country.

- Income and profits from hydrocarbons situated in the UAE will remain subject to the domestic laws and regulations of the UAE. [Article 3 of the DTA refers.]
- Income from immovable property will generally remain taxable in the country where the property is situated. [Article 7 of the DTA refers.]

- Business profits of an enterprise will be taxable only in the country where the enterprise is resident unless the profits are derived through a permanent establishment situated in the other country. In that case the profits may be taxed in that country. A permanent establishment is essentially a fixed base in the country in question where the business of an enterprise is carried on. [Article 8 of the DTA refers.]
- Profits of an enterprise of a country from the operation of ships or aircraft will be taxable only in that country. Such profits may also be taxable in the other country where the profit relates to operations confined solely to places in that other state. [Article 9 of the DTA refers.]
- Dividends paid by a company of one country to a resident of the other country may be taxed in that other country. The source country may also tax the dividend up to a maximum of 15 per cent on the gross amount of the dividends. [Article 11 of the DTA refers.]
- Interest may generally be taxed in both countries. However, the country in which the interest arises must not impose tax in excess of 10 per cent. In cases where the Government of a country or a Government owned financial institution derives interest from the other country, the country in which the interest arises cannot impose any tax. Paragraph 9 of the Protocol clarifies that the ADIA and DIDA are recognised as being an integral part of the Government for these purposes. [Article 12 of the DTA refers.]
- Royalties may generally be taxed in both countries. However, the country in which the royalties arise must not impose tax in excess of 10 per cent of the royalties. [Article 13 of the DTA refers.]
- Specific rules apply to the taxation of income, profits or gains derived from the alienation of property. In the case of immovable property the gains are taxable where the property is situated. In the case of movable property the gains are generally taxable in the country in which the alienator is resident. [Article 14 of the DTA refers.]
- Income from employment will be taxable only in the country where the employee is resident, unless the employment is performed in the other country. In this case, the country where the employment is performed may also tax the income, if the employee is present for more than 183 days and certain other conditions are met. [Article 16 of the DTA refers.]
- Directors' fees may be taxed in the country in which the company is resident. [Article 17 of the DTA refers.]
- Entertainers and sportspersons may be taxed in the country in which the activities of the entertainer or sportsperson take place. The country in which the activities take place cannot impose tax if the entertainer or sportsperson is sponsored by the Government of the other country. [Article 18 of the DTA refers.]
- Pensions and annuities are taxable only in the country where the recipient is resident. Government pensions are in limited circumstances taxable in both States. [Articles 19 and 20 of the DTA refer.]

- Salaries and wages for services to a Government of one country are generally exempt from tax in the other country. [Article 20 of the DTA refers.]
- Students from one country who study in the other country are generally not taxed on payments received from outside the country when those payments are for the maintenance and education of the student. However a person can only benefit from this for five fiscal years. [Article 21 of the DTA refers.]
- New Zealand has to comply with the various administrative requirements of the DTA that make its operation possible. These include, in particular, the elimination of double taxation by giving credits for overseas tax paid in certain situations; complying with the mutual agreement procedures set out in the DTA; and complying with the exchange of information procedures. [Articles 23 , 24 and 25 of the DTA refer.]
- Sovereign immunity from income tax is provided to the Government of the United Arab Emirates, including agencies that form an integral part of the Government. In essence, this means that transactions in New Zealand by the United Arab Emirates Government or its agencies that are of a 'government' rather than a commercial nature are exempt from income tax. [Paragraph 9 of the Protocol refers.]
- The Abu Dhabi Investment Authority and the Dubai Investment and Development Authority are recognised as government institutions by the competent authorities of the Contracting States. [Paragraph 1 of the Protocol and Paragraph 9 of the Protocol refers.]
- The provision in the DTA that refers to Income from Employment shall apply from the 27 October 2002. [Paragraph 11 of the Protocol refers.]

Economic, Social, Cultural and Environmental Effects

19 No social, cultural or environmental effects are anticipated. Any economic effects are expected to be favourable, as noted above.

Costs

20 New Zealand may forgo some revenue from the limitation of our taxing rights in relation to income flows between New Zealand and the UAE which we are currently able to tax under our domestic laws. This revenue cost could include, for instance, tax forgone in relation to short-term activities of the UAE residents in New Zealand which the DTA will exempt. It could also include tax forgone on dividends, interest and royalties paid by New Zealand residents to the residents of the UAE in respect of which, the DTA will lower withholding rates. This could result in a revenue loss in relation to revenue collected on any existing investment from the UAE. The extent of this revenue cost, if any, depends on whether significant investment activity would take place in New Zealand in the absence of a DTA. Discussions with the UAE indicate that this would be unlikely. However, if as a result of the new DTA, UAE investment in New Zealand increases significantly, the revenue collected on that new investment together with the economic benefits associated with the new investment, will outweigh any such revenue cost.

Future Protocols

21 No future protocols are anticipated.

Implementation

22 Subject to the successful completion of the international treaty examination process, this DTA will be implemented by Order in Council in accordance with section BH 1(3) of the Income Tax Act 1994.

23 This agreement will be implemented by way of an overriding treaty regulation. Section BH 1 of the Income Tax Act 1994 enables DTAs to be given effect by Order in Council. It also provides that the DTA will override the Income Tax Act 1994 and any other enactment relating to income tax, unpaid tax and the exchange of information relating to a tax. This override is necessary to give effect to the terms of the DTA and will effectively override the Income Tax Act 1994, the Tax Administration Act 1994.

Consultation

24 The Treasury agrees with the terms of the DTA. No private sector consultation was entered into.

Withdrawal or Denunciation

25 Article 28 of the DTA provides that either contracting country may terminate the DTA by giving notice, through diplomatic channels, of termination on or before 30 June in any calendar year beginning after the expiration of five years from the date of its entry into force.

Annex 14 Relevant Laws and Policies

- Income Tax Law 1985 as amended (Jordan).
- Recent Jordanian DTAs.
- Internal Revenue Code (US).
- US Model DTA and relevant US DTAs.
- Other laws and policies referred to in the endnotes and footnotes.

Annex 15 UN Manual: Procedural Suggestions for Tax Treaty Negotiations (2003)

IV. PROCEDURAL ASPECTS OF TAX TREATY NEGOTIATIONS

The procedural aspects of negotiating a tax treaty include the identification of the need for a treaty, the establishment of contracts with a potential treaty partner, the appointment of a delegation, the preparations for negotiations, the conduct of the negotiations and procedures for bringing the treaty into force.

A. Identification of need for a treaty

In determining whether a need exists for a tax treaty with a particular country, a country should examine the nature and extent of the existing economic relationship between the two countries as well as the potential and desire for growth in that relationship. In particular, there should be an intelligent assessment of the nature of future economic relationship. For example, a country should consider the likelihood of foreign direct or portfolio investment from the country concerned, the possibility of the country's technical or managerial personnel coming for employment, and the likelihood that residents of the other country will set up branches, offices or subsidiaries within its territorial jurisdiction. In addition, the country should examine whether the interrelationships between the tax systems of the two countries are inhibiting economic relationships. These inhibiting effects may, for example, be the results of excessively high levels of tax on international income flows, inadequate statutory relief from double taxation, and conflicting definitions of terms or concepts. Finally, a country should attempt to determine whether, to what extent and for what reasons the tax systems of the two countries result in double taxation on residents of the two countries.

B. Initial contacts

Once a country has identified the need for entering into a treaty with a particular country, it must communicate to that country its desire to open negotiations. As a general rule, such contacts are made initially through diplomatic channels. When a personal relationship exists between tax officials in the two countries, however, it may be helpful to utilize that relationship. In that event, the official diplomatic contacts should be supplemented by informal contacts through these personal channels.

When necessary, this initial contact phase may be the appropriate time to request information or other materials on the tax system and tax treaties of the other country.

C. Appointment of a delegation

A delegation typically consists of three to five individuals, although this number by no means reflects a hard and fast rule.

The leader of the delegation should be a senior official with tax policy responsibility who has the authority to make independent policy decisions, at least on a tentative basis.

The members of the delegation should be individuals who, among them, combine most or all of the following skills:

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See Part 3 of the *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* (UN, 2003, New York) (Doc. ST/ESA/PAD/SER.E/37) pp 172-177 available at <http://www.unpan.org/analytical_report.asp>.

(a) Familiarity with the administrative aspects of tax treaties and with the administration of the international aspects of internal law. An individual having such familiarity would represent, in effect, the competent authority function on the delegation;
(b) A lawyer who is familiar with domestic tax law and able to draft treaty provisions;
(c) An economist or other individual with an understanding of the economic relationships between the two countries and an ability to assess the economic impact of the decisions being made in the course of the negotiations.

If negotiations are to be held in a country's home capital, the opportunity may be taken to bring other people into the negotiations for training purposes. If this is to be done, however, care should be exercised to keep the delegations from becoming so big as to "overpower" the visiting delegation.

Finally, it is most important that one member of the delegation be assigned responsibility for taking careful notes of the discussions.

D. Preparations for negotiations

Members of the delegation should participate, possibly along with others, in preparing for the negotiations. The preparations typically include the following steps:

(a) The tax system of the other country and its existing tax treaties must be studied. The other treaties provide an indication of the range of positions acceptable to the other country;
(b) A draft treaty or working paper should be prepared showing initial positions on the major issues in a tax treaty. This draft may be in general form, to be used for all treaty discussions, or it may be geared to the particular discussions being undertaken. This draft should be transmitted to the other delegation. Though this step is useful for advising the other delegation of positions to be taken in the negotiations, it is also useful for the members of the delegation that prepares it, in requiring them to focus clearly on their own positions;
(c) If the other delegation has prepared a similar draft or working paper, the two drafts should be compared and positions should be prepared on all points of difference;
(d) In working out a country's position, the following groups should be consulted to suggest issues from their own experience: (i) the business community in the country; (ii) that country's citizens who are in the other country (the country's embassy in the other country can carry out this function); and (iii) other government agencies (e.g., investment agencies, government marketing boards, etc.);
(e) If the country does not have any of its nationals available who are familiar with the tax laws of the other country, it may wish to engage an outside expert as a consultant;
(f) It is most useful if at least one member of the delegation is familiar with the United Nations Model Convention, the OECD Model Convention and any relevant regional model treaties.

E. Arrangements for meetings between negotiating delegations

Experience has shown that negotiations typically require at least two rounds of discussions, sometimes more, which are usually held on an alternating basis in the two capitals.

It is common experience that one week is an optimal length for a round of discussions. By the end of a week, there is usually an accumulation of issues that require careful consideration with principal officials before final decisions can be made. Furthermore, as a purely practical matter, officials frequently find that the amount of work that piles accumulates during the discussions can become intolerable when treaty discussions extend more than a week at a time.

In arranging for the meetings, the host delegation should make certain that: (a) there is a common language for negotiations, or (b) that interpreters will be available who can deal with tax concepts and terminology in both languages.

F. Conduct of the negotiations

1. First round of negotiations

It is helpful, as a first order of business, to make certain that each side understands the tax system of the other, particularly as it relates to the taxation of international income flows. If there are particularly complex aspects of a country's tax law that are relevant for a tax treaty, it is often helpful for that country to prepare a brief explanation in written form for the other delegation.

Once there is a general understanding of the two tax systems, the negotiations themselves can begin with an article-by-article review of the draft or drafts previously prepared. If neither side has its own model or draft, the United Nations Model Convention can be used for this purpose. During this initial article-by-article review, agreement can be reached on relatively easy points, and a clarification and, in some cases, a narrowing of the differences can be achieved on the remaining points.

If time remains after concluding one complete review of the draft, a second article-by-article review can be started. At this point, greater effort should be devoted to reaching agreement.

At the conclusion of the week's discussions, it is useful to prepare an agreed statement of the open issues and, if possible, to schedule the next meeting.

2. Between the first and second rounds of the negotiations

It should be agreed at the conclusion of the first round that one side will prepare a draft showing agreed language and, by use of brackets and alternative language or other suitable symbols, the open issues. This document should be the discussion draft for the second round.

It is important that the notes of the discussions be recorded and distributed to members of the delegations as quickly as possible, while memories are still fresh, particularly if there is more than one treaty under negotiation at the time.

Between the two rounds, the heads of the delegations should correspond in order to exchange drafts, to indicate tentative conclusions on major open issues and to confirm the schedule for the next round of discussions.

3. Second round of negotiations

It is important to maintain both momentum and continuity in treaty negotiations. Thus, the time between rounds should be minimized and, to the extent possible, the composition of the delegations should be retained.

Before resuming the article-by-article or issue-by-issue review of the draft, there should be a brief discussion of changes, if any, in the tax laws of either country between the first and the second rounds.

The review of the common working draft should continue, further narrowing any differences which remained at the beginning of the second round. Although it is generally best not to reverse prior decisions, this possibility should not be ruled out if either side considers it necessary. All decisions at this stage are made subject to policy review.

On occasion, agreements are reached in the course of negotiations that do not readily lend themselves to inclusion in the treaty but that should be made public at some time. There may be, for example, an agreed interpretation of a treaty provision, that is too detailed to go into the treaty text. This interpretation may be spelled out in an exchange of letters to be signed at the same time as the treaty. Such letters of understanding normally would not be subject to ratification, but would form part of the public record.

If full agreement has been reached by the conclusion of the second round, the treaty should be initialled by the heads of delegations. Initialling indicates that the draft reflects the agreement reached at the negotiating level.

If full agreement has not been reached, but nonetheless seems possible, the procedures suggested in the subsections F.2 and F.3 may be repeated. Although it may be possible, at this stage, to conclude an agreement by correspondence, there may be value in scheduling a third, perhaps briefer, meeting so as not to lose momentum. It is sometimes much easier to understand each other's point of view in face-to-face discussions.

G. Preparations for the signature of the treaty

Once agreement has been reached at the delegation level, the draft should be reviewed by senior policy officials. At this stage, to an even greater extent than during the negotiations, frivolous or minor changes should be avoided, but if a strong policy reason for proposing a change in the

initialled draft is perceived, this information should be communicated immediately to the other delegation.

Once the draft is fully agreed upon, arrangements should be made for signature at the earliest opportunity under the appropriate procedures in each country. The need to conform texts in two languages can make this stage a time-consuming process. The printing, binding and sealing of agreed texts for signature is normally handled by foreign ministries.

H. Miscellaneous considerations

Countries may find it useful to issue press releases or other public statements that negotiations are about to begin with a particular country. The purpose of such a statement is to solicit comments from interested parties. This procedure may serve two purposes. It may bring to light issues that tax officials had not previously been aware of. Also, those in the private sector appreciate the opportunity to participate in the treaty process.

The negotiations are normally treated as confidential until the treaty is signed. This requirement of confidentiality has at least two positive purposes. It avoids locking negotiators into what may have been intended as tentative negotiating positions. It also avoids subjecting negotiators to pressures from parties who would be affected by these tentative decisions.

Countries may wish to consider a procedure for reviewing the progress of negotiations, during their course, with interested parties in the private sector. This review can most profitably be done after the general pattern of the new treaty has been established but before final decisions are made. It can serve to apprise the negotiators of some issues that may have surfaced after the beginning of the negotiations, or of problems that could result from provisions already tentatively agreed to. In such meetings, however, caution must be exercised to avoid revealing negotiating positions and other confidential information.

It is useful for the negotiators to maintain contact with economic officers in their embassy in the capital of the other country and to keep them advised of the progress of the negotiations. Among other things, this facilitates the role of these officers in exchanging messages and other communications between formal negotiation sessions. These officers often will sit in on negotiations held in the country where they are assigned.

Finally, experience has shown that social contacts between delegations during the negotiations often are most helpful in maintaining a high level of good will between the delegations. The value of such social contacts is in no way correlated with their elaborateness or cost.